(11)

No. 94-1239-CSX   Title: Fulton Corporation, Petitioner
Status: GRANTED   v.
                          Janice H. Faulkner, Secretary of Revenue of North Carolina

Docketed:
January 17, 1995   Court: Supreme Court of North Carolina

Counsel for petitioner: Cummings Jr.,Jasper L.

Counsel for respondent: Mudge,Marilyn, Rothfeld,Charles

NOTE: 011895 consulted Frank re respond-JUSTUS no longer sec.

Entry	Date	Note	Proceedings and Orders
1	Jan 17 1995	G	Petition for writ of certiorari filed.
2	Jan 23 1995		Letter from petitioner in compliance with Rule 29.1 filed.
4	Feb 16 1995		Brief of respondent Janice Faulkner, Secretary of Revenue in opposition filed.
3	Feb 22 1995		DISTRIBUTED. March 17, 1995 (Page 2)
5	Apr 10 1995		REDISTRIBUTED. April 14, 1995 (Page 26)
6	Apr 17 1995		Petition GRANTED. **
7	May 30 1995		Joint appendix filed.
8	May 30 1995		Brief of petitioner Fulton Corporation filed.
9	Jun 13 1995	D	Motion of respondent to dismiss the writ of certiorari as improvidently granted filed.
10	Jun 19 1995		Opposition of petitioner to motion of respondent filed.
12	Jun 20 1995	X	Brief of respondent in support of the motion to dismiss filed.
14	Jun 26 1995		Motion of respondent to dismiss the writ of certiorari as improvidently granted DENIED.
16	Jun 30 1995		Order extending time to file brief of respondent on the merits until July 24, 1995.
17	Jul 5 1995		Brief amicus curiae of Commonwealth of Kentucky Revenue Cabinet filed.
18	Jul 24 1995		Brief of respondent Janice H. Faulkner, Secretary of Revenue filed.
19	Jul 24 1995		LODGING consisting of Report of the Tax Commission submitted by counsel for the respondent filed.
21	Aug 21 1995		Record filed.
		*	Certified record proceedings Supreme Court of North Carolina.
20	Aug 28 1995		Reply brief of petitioner filed.
22	Sep 5 1995		SET FOR ARGUMENT TUESDAY, OCTOBER 31, 1995. (1ST CASE).
23	Sep 8 1995		CIRCULATED.
24	Oct 31 1995		ARGUED.

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FILED

(1) 94 1239 JAN 17 1995

No.

OFFICE OF THE CLERK

IN THE
SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

V.

BETSY Y. JUSTUS, SECRETARY OF REVENUE,

Respondent.

Petition for Writ of Certiorari to the Supreme Court of North Carolina

PETITION FOR WRIT OF CERTIORARI

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67 pp

QUESTION PRESENTED

Whether the North Carolina intangible personal property tax on the value of corporate stock owned by shareholders discriminates against interstate commerce, or otherwise violates the United States Constitution, by taxing one hundred percent of the value of stock of corporations that do no business in North Carolina, but exempting from taxation the stock of corporations that do business only in North Carolina, and reducing the taxable value of the stock of other corporations proportionately as the amount of business done by the corporation in North Carolina increases.

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In The
Supreme Court of the United States

October Term, 1994

FULTON CORPORATION,
Petitioner,

V.

BETSY Y. JUSTUS, SECRETARY OF REVENUE,
Respondent.

Petition for a Writ of Certiorari to the
Supreme Court of North Carolina

Fulton Corporation (herein "Taxpayer") respectfully petitions for a Writ of Certiorari to review the judgment of the Supreme Court of North Carolina in this case.

OPINION BELOW

The Opinion of the Supreme Court of North Carolina (Appendix A, *infra*, 1a-17a) is reported at 1994 WL 685491 (N.C. 1994). That opinion reversed the decision of the North Carolina Court of Appeals (Appendix B, *infra*, 18a-35a), reported at 110 N.C. App. 493, 430 S.E. 2d 494 (1993).

JURISDICTION

The Supreme Court of North Carolina issued its opinion on December 9, 1994 and the clerk entered the judgment and issued the mandate of the court on

December 29, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article 1, Section 8, clauses 1 and 3 of the United States Constitution provide in relevant part:

> The Congress shall have Power To . . . regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes; . . . .

Pertinent portions of the North Carolina taxing statutes (N.C. Gen. Stat. §§ 105-203, 105-130.7, 105-130.4 and 105-130.3) appear in Appendix C at pp. 36a-38a.

STATEMENT OF THE CASE

A. Procedural Background and How the Federal Question Was Presented

Taxpayer sued the North Carolina Secretary of Revenue in the Superior Court in May 1991 complaining that N.C. Gen. Stat. § 105-203 violates the Commerce Clause and the Fourteenth Amendment to the United States Constitution, insofar as the statute imposes an intangible personal property tax on some or all of the value of corporate stock owned by Taxpayer. The trial court allowed the Secretary's summary judgment motion and denied Taxpayer's. Taxpayer appealed and relied on the Commerce Clause and the Fourteenth Amendment in its brief.

The North Carolina Court of Appeals on 15 June 1993 filed its unanimous opinion reversing the trial court's decision on the merits and remanding the cause for entry of a judgment declaring the intangibles tax provision at issue to be in violation of the Commerce Clause. *Fulton Corp. v. Justus*, 110 N.C. App. 493, 430 S.E.2d 494 (1993), Appendix B, *infra*, 18a-35a.[1] The opinion identified as the offending provision the deduction from the tax base contained in N.C. Gen. Stat. § 105-203(1), which deduction increases as the amount of business done in the state by the stock-issuing corporation increases.

The Supreme Court of North Carolina reversed the decision of the Court of Appeals, reinstating the decision of the Superior Court, and ruling that the intangibles tax on stock does not violate the Commerce Clause. The decision declined to consider Taxpayer's other constitutional claims.[2] *Fulton Corp. v. Justus*, 1994 WL 685491 (N.C. 1994), Appendix A, *infra*, 1a-17a.

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[1]Taxpayer does not here seek review of the federal issues raised by the adverse decision of the North Carolina Court of Appeals on its refund demand and its request for attorneys fees because that decision was reversed by the Supreme Court of North Carolina and is not the final decision of the highest state court. Taxpayer understands that those issues can be reconsidered by the North Carolina courts in the event that this Court reverses and remands the North Carolina Supreme Court's decision, and should an adverse decision again be made by the North Carolina Supreme Court on those issues, Petitioner can seek review by this Court at a later time.

[2]Taxpayer wishes to preserve the right to rely on the Fourteenth Amendment, although its application is not further discussed herein.

B. North Carolina Intangibles Tax Scheme

North Carolina imposes a property tax on the fair market value of certain financial intangibles, including corporate stock, which is taxed to shareholders. The tax is not imposed uniformly on the full fair market value of all taxpayers' stocks. Instead, the owners of the stock of certain corporations can deduct from the full value a percentage thereof, up to and including one hundred percent.

The deduction is one hundred percent if one hundred percent of the business activities of the corporation issuing the stock occurred within North Carolina in a specified earlier year. N.C. Gen. Stat. §§ 105-203(1), 105-130.7(1), 105-130.4. Examples include incorporated purely local businesses such as corner drugstores, professional associations and the like. The stock of such corporations owned by North Carolina residents is free of intangibles tax.

No deduction from the full fair market value of the stock is allowed if the corporation is a foreign corporation that did no business in North Carolina in a specified earlier year. *See* N.C. Gen. Stat. § 105-130.3 (under which such a corporation is not subject to the state's corporate income tax). Examples are large national corporations such as Exxon Corp., Ford Motor Co. and Raytheon Corp. ("Stock and Bond Values as of December 31, 1990" in Exhibit Notebook that is part of the Record in the North Carolina appellate courts, hereinafter "Record Exhibit Notebook")

In other cases the deduction is a percentage of the stock's value equal to the percentage determined by

comparing its business activities in North Carolina with all of its business activities. Corporations in this latter category can be referred to as multistate corporations that do business in North Carolina. *See* N.C. Gen. Stat. § 105-130.4(b). While this group includes domestic North Carolina corporations that do some business outside the state, most commonly it includes large national corporations that do a small amount of business in the state, such as IBM (5%) and General Electric (1%). (Record Exhibit Notebook)

The percentage of a multistate corporation's business activities in North Carolina is quantified by use of the allocation and apportionment rules of the North Carolina corporate income tax. N.C. Gen. Stat. § 105-203(1), § 105-130.7(1), § 105-130.4. The allocation rules allocate to North Carolina all of the nonbusiness income from certain passive investments (i.e., interest and dividends received by a corporation whose commercial domicile is in North Carolina, and rents received from property located in North Carolina). N.C. Gen. Stat. § 105-130.4(c) - (h). The apportionment rules apportion to North Carolina that part of the corporation's business income earned in the state, determined by comparing its payroll, property and sales activities within the state to the totals thereof and averaging the three percentages, with the sales percentage being double weighted. N.C. Gen. Stat. § 105-130.4(i) - (l).

In practice, shareholders determine their intangibles tax bases by multiplying the full value of their stock in a corporation by the corporation's "taxable percentage," which the Secretary of Revenue determines and publishes annually for a large number of corporations. For example,

the taxable percentage for 1990 for IBM was 95% and for General Electric was 99%. (Record Exhibit Notebook)

C. **Application of the Intangibles Tax to Taxpayer**

It is undisputed that the North Carolina intangibles tax applied as follows to the stocks owned by Taxpayer on December 31, 1990. Most of Taxpayer's stocks were "100% taxable." This means that the issuing corporations were neither domiciled in North Carolina nor did business in or earned income from North Carolina (and so were not subject to the North Carolina corporate income tax). Taxpayer was charged intangibles tax on 100% of the market value on December 31, 1990 of the stock of such corporations. Taxpayer owned stock of one corporation that did part of its business in North Carolina, Food Lion, Inc. Its stock's taxable percentage was 54%, meaning that 46% of Food Lion's business was done in North Carolina (and 46% of its net income was allocable to North Carolina for corporate income tax purposes). (Record in North Carolina appellate courts, p. 49)

D. **Proceedings Below**

The North Carolina Court of Appeals ruled that the intangibles tax on stock facially discriminates against interstate commerce because "shareholders of out-of-state corporations are required to pay intangibles taxes on a higher percentage of shares [values] than shareholders of corporations operating solely in North Carolina." 110 N.C. App. at 499, 430 S.E.2d at 498. The Court of Appeals recognized the applicability of this Court's internal consistency test for Commerce Clause violations, which asks whether the state's tax regime, if adopted by all

states, would necessarily result in discrimination against interstate commerce. *See Armco, Inc. v. Hardesty*, 467 U.S. 638, 104 S. Ct. 2620, 81 L. Ed. 2d 540 (1984). The Court of Appeals rejected the Secretary of Revenue's argument that the property tax imposed on stock was a "compensating tax" designed simply to make interstate commerce bear a burden already borne by intrastate commerce in the form of the corporate income tax. The Court of Appeals found the property tax on stock and the income tax on corporations not to be imposed on substantially equivalent events whose taxation at the same rate could be comparable. This Court has ruled that a tax may be considered a compensating tax only when imposed on substantially equivalent events. *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815, 1821, 128 L. Ed. 2d 639 (1994).

Finally, the Court of Appeals distinguished the 1912 decision of this Court in *Darnell* because it involved a property tax on stock that treated the stock as embodying the corporate property, which also was subject to the state's property tax; the Court of Appeals found no similar effort by North Carolina to tax corporate property once. *Darnell v. Indiana*, 226 U.S. 390, 33 S. Ct. 120, 57 L. Ed. 267 (1912).

Darnell involved an Indiana property tax on the value of stock owned by shareholders and a separate Indiana property tax on the value of tangible property owned by corporations. Shareholders of domestic corporations could deduct from their stock's value the value of the corporation's tangible property taxed by Indiana. Thus, Indiana treated the shareholder's stock value as embodying the value of the tangible property owned by the domestic corporation, plus any intangible

value. The complaining Indiana taxpayer in *Darnell* owned stock in a Tennessee corporation, which did not own property in Indiana. His stock in the Tennessee corporation was taxed at one hundred percent of its value. The United States Supreme Court ruled that the Indiana scheme treated the Tennessee corporation and domestic Indiana corporations with "substantial equality" because Indiana taxed the property of domestic corporations and taxed as property the stock of foreign corporations.

On appeal from the Court of Appeals, the Supreme Court of North Carolina did not dispute the facial discrimination of the North Carolina intangibles tax, but found that the *Darnell* decision controlled and required it to accept North Carolina's compensating tax defense to the facial discrimination. The Supreme Court of North Carolina ignored the discrimination inherent in the North Carolina scheme's violation of the internal consistency test.

REASONS FOR GRANTING THE PETITION

The North Carolina Supreme Court's decision highlights the need to resolve a conflict between this Court's compensating tax defense to Commerce Clause violations and its internal consistency test, which identifies Commerce Clause violations.

I. The Supreme Court of North Carolina Decided an Important Question of Federal Law That Has Not Been, But Should Be, Settled By This Court: the Current Force of *Darnell v. Indiana*; In Doing So, the Supreme Court of North Carolina Ignored Applicable Decisions of this Court

A. Summary

The North Carolina Supreme Court concluded that the *Darnell* decision specifically, and the compensating tax defense generally, permit a state to prove that its facially discriminatory tax does not effectively discriminate against interstate commerce *solely* by analyzing the effect of other taxes imposed by that one state. Two other state appellate courts have used the same approach to reject Commerce Clause objections to their state's taxes within the last four years. *Indiana Department of State Revenue v. Felix*, 571 N.E. 2d 287, 292 (1991), *cert. dismissed*, 112 S. Ct. 1073, 117 L. Ed. 2d 278 (1992); *St. Ledger v. Commonwealth of Kentucky*, No. 92-CA-2688-MR (Ky. App. May 20, 1994), *motion for discretionary review granted*, No. 94-SC-468-D (Ky. October 19, 1994). This approach conflicts with the more recent decisions of this Court applying to state taxes the test of internal consistency to determine whether discrimination against interstate commerce would necessarily result if the subject state's tax regime were adopted by all states. Unless this Court resolves this confusion about the present validity of the *Darnell* holding in this context and the compensating tax defense, the practical effect is likely to be that other state courts will follow the pattern of these three decisions, thus ignoring this Court's modern Commerce Clause decisions flowing from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S. Ct. 1076, 51 L. Ed. 2d 326, *reh'g denied*, 430 U.S. 976, 97 S. Ct. 1669, 52 L. Ed. 2d 371 (1977).

B. The *Darnell* Decision Considered Multiple Taxation Only Obliquely

This Court has held that a violation of the Commerce Clause can be discerned by application of the

internal consistency test to determine whether the state tax scheme necessarily results in multiple taxation of interstate commerce by states. *See Goldberg v. Sweet*, 488 U.S. 252, 261, 109 S. Ct. 582, 589, 102 L. Ed. 2d 540 (1984). The North Carolina Supreme Court relied *solely* on *Darnell* in reversing the North Carolina Court of Appeals, stating that it was "loath to conclude that a Supreme Court decision [*Darnell*] has been implicitly overruled, ..." *Darnell* did not directly deal with multiple taxation.

The *Darnell* decision alluded in the following single sentence to the concern that Mr. Darnell's Tennessee corporation might also pay property tax in Tennessee, thus resulting in greater aggregate property tax on the Tennessee corporation and its Indiana shareholder than on an Indiana corporation and its Indiana shareholder:

> The case is pretty well disposed of by *Kidd v. Alabama*, 188 U.S. 730, 23 Sup. Ct. Rep. 401, 47 L. Ed. 669, [1903], where the real matter of complaint, that the property of the corporation presumably is taxed in Tennessee, is answered.

226 U.S. at 398.

However, *Kidd v. Alabama* did not discuss the Commerce Clause. It dealt only with a Fourteenth Amendment argument and stated:

> We say that the state in taxing stock may take into account the fact that the property and franchises of the corporation are untaxed, whereas in other cases they are taxed; and we say untaxed, because they are not taxed by the state in question. The real grievance in a case like the present is that, more than probably, they are taxed elsewhere. But with that the state of Alabama is not concerned. No doubt it would be a great advantage to the country and to the individual states if principles of taxation could be agreed upon which did not conflict with each other, and a common scheme could be adopted by which taxation of substantially the same property in two jurisdictions could be avoided. But the Constitution of the United States does not go so far.

188 U.S. at 732.

Thus, the *Kidd* decision was inapposite to *Darnell*, a Commerce Clause case.

C. The Supreme Court of North Carolina Treated the Compensating Tax Defense as Preempting the Internal Consistency Test, In Conflict with Applicable Decisions of this Court

The Supreme Court of North Carolina relied on *Darnell* to ignore the method of analysis established by this Court for a facially discriminatory tax for which a compensatory tax defense is proposed: *first*, is the tax facially discriminatory; if so, *second*, does the compensatory tax result in equality of in-state taxation; and *third*, even if so, does the combination of the two state taxes nevertheless violate the internal consistency test? *See Armco, Inc. v. Hardesty,* 467 U.S. 638, 104 S. Ct. 2620, 81 L. Ed. 2d 540 (1984); *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987).

Reliance on *Darnell* for ignoring the internal consistency test was improper. The *Kidd* decision simply stands for the well known principle that the Due Process Clause does not forbid multiple taxation by states. *See Curry v. McCanless*, 307 U.S. 357, 59 S. Ct. 900, 83 L. Ed. 1339 (1939). Viewed in the light most favorable to the Secretary of Revenue, the single sentence quoted above from the *Darnell* decision extended this view to apply also to the Commerce Clause in 1912 in a case involving alleged multiple state taxation of the same property. In 1991 this Court affirmed by an equally divided vote a decision of the District Court of Appeal of Florida that the Commerce Clause did not preclude Florida from taxing property that also was taxed by another state. *Ford Motor Credit Company, Inc. v. Department of Revenue*, 537 So. 2d 1011 (Fla. Dist. Ct. App.), *aff'd*, 500 U.S. 172, 111 S. Ct. 2049, 114 L. Ed. 2d 232 (1991) (equally divided Court). Whatever that affirmance might imply, the instant case does not raise the difficult issues surrounding taxation of the same property by two states, each of which has a reasonable ground for taxing it. See *Etting v. President, Directors & Co. of Bank*, 11 Wheat. 59 (1826) (holding that affirmance by equally divided U.S. Supreme Court does not settle principles involved).

Rather, this case raises the issue whether a facially discriminatory property tax can be made nondiscriminatory in effect by imposing an income tax on another group of taxpayers, when the nationwide adoption of that taxing regime would inevitably result in heavier taxation in the aggregate of interstate commerce than intrastate commerce.

Example: Corporation X does business only in State A and so will pay tax there on 100% of its income; if all its shareholders reside in State A, they will pay no intangibles tax. However, if Corporation X does half of its business in State B, it will still pay income tax on about 100% of its income (about half of its income will be taxed by each of State A and B); its shareholders in State A will pay intangibles tax on half of the value of their stock. By entering into interstate commerce, Corporation X causes an increase in the aggregate taxation of itself and its shareholders. If State A either taxed all of the value of stock owned by its residents, or imposed no tax on stock, no discrimination would exist.

This Court has ruled that the Commerce Clause requires a fair apportionment of the tax burden, and so forbids multiple taxation of income from interstate commerce by states. See *Allied-Signal, Inc. v. Director*, 112 S. Ct. 2251, 2258, 119 L. Ed. 2d 533 (1992). To ferret out multiple taxation this Court has applied the internal consistency test, which is failed by a state tax that, if adopted by all states, would necessarily result in multiple taxation of interstate commerce. The application of the internal consistency test is not limited to corporate income taxes. See *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266, 284-286, 107 S. Ct. 2829, 97 L. Ed. 2d 226 (1987) (ruling that facially nondiscriminatory Pennsylvania flat taxes on trucks failed the internal consistency test); *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987) (involving a facially discriminating gross receipts tax and making clear that the *risk* of multiple taxation under the internal consistency test on out-of-state businesses constitutes a discrimination that violates the Commerce Clause); *Goldberg v. Sweet*, 488 U.S. 252, 261, 109 S. Ct.

582, 589, 102 L. Ed. 2d 607 (1989) (involving a telecommunications tax and stating that the state tax must not cause multiple taxation under the internal consistency analysis); *Armco, Inc. v. Hardesty*, 467 U.S. 638, 104 S. Ct. 2620, 81 L. Ed. 2d 540 (1984) (involving a facially discriminatory manufacturing tax and a wholesaling tax); *Container Corp. of America v. Franchise Tax Bd*, 463 U.S. 159, 169, 103 S. Ct. 2933, 2942-2943, 97 L. Ed. 2d 545 (1983) (involving franchise tax based on income).

The only distinctive feature of the application of the internal consistency test here is the aggregation of taxation of related taxpayers. This Court has never applied the internal consistency test in a case involving such aggregation (although *Darnell* obliquely raised the issue). This Court should determine and make clear whether *Darnell v. Indiana* specifically, and the compensating tax defense generally, can be relied upon in Commerce Clause cases to restrict the scope of a court's analysis of a combination of corporate income and shareholder property taxes to only those taxes imposed by the one state.

II. The Decision of the Supreme Court of North Carolina Conflicts in Principle With a Decision of a United States Court of Appeals and With Views Stated by this Court

The unresolved issue raised here is essentially the same as the question whether a single state's facially discriminatory use tax on goods purchased from out of state, in combination with its exactly equivalent and compensating sales tax on goods purchased in the state, nevertheless discriminates against interstate commerce by failing to allow a credit against the state's use tax for sales

tax paid to another state on the same property by the same taxpayer. Both cases require attention to the potential taxation by other states. This Court recently has declined to issue its writ of certiorari to the Second Circuit in a case where the Second Circuit ruled that the absence of such a credit did result in discrimination against interstate commerce due to a violation of the internal consistency test. *Barringer v. Griffes*, 1 F.3d 1331 (CA2 1993), *cert. denied*, 114 S. Ct. 879 (1994). The Second Circuit decision cited substantial authority from this Court indicating that absence of such a credit is fatal under the Commerce Clause, although commentators state that this Court has not ruled that a credit is required.[3]

III. The Supreme Court of North Carolina Has Decided a Federal Question in a Way that Conflicts With Applicable Decisions of this Court, by Misapplying *Darnell* and the Compensating Tax Defense

A. Summary

The opinion of the North Carolina Supreme Court conflicts with applicable decisions of this Court in that (1) it extends the holding of *Darnell* to facts that this Court does not intend to be controlled by *Darnell*, and (2) it ignores the more recent opinions of this Court defining the scope of the compensating tax defense.

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[3]Hellerstein & Hellerstein, *State Taxation II, Sales and Use, Personal Income, and Death and Gift Taxes*, ¶ 18.08[2] (1992). *But see Tyler Pipe Industries, Inc. v. Washington State Dept. of Rev.*, 483 U.S. 232, 245-247, 107 S. Ct. 2810, 2818-2819, 97 L. Ed. 2d 199 (1987) (indicating that a credit is required).

B. **Misuse of the *Darnell* Decision Undercuts This Court's Authority to Interpret the Constitution**

Darnell accepted the defendant state's compensating tax defense (without using that term) to a Commerce Clause challenge to a facially discriminatory state tax, on facts that differ radically from those at issue here. *Darnell* involved a state property tax on domestic corporations that was found to compensate for a facially discriminatory reduction of a state property tax on stock of domestic corporations. The North Carolina Supreme Court attempted to stretch this method of tax equalization to cover a state income tax on corporations doing business in the state, in combination with a state administered tax on corporate stock. The *Darnell* court thought it was sanctioning the taxation of the property of corporations once by Indiana. No such interrelationship exists in North Carolina because the corporate income tax is not a property tax and does not reflect in any direct way the amount and value of property of the corporation in the state or the value of the corporate stock.

C. **The Supreme Court of North Carolina's Decision Not Only Conflicts with but Ignores Compensating Tax Decisions of this Court**

Subsequent to the 1912 *Darnell*[4] decision this Court identified as such the compensating tax defense to objections to a state tax that facially discriminates against interstate commerce. This defense was not and cannot be proved in this case, even if one restricts the analysis to the taxes imposed by North Carolina alone, because there is no comparability between taxing stock as property and taxing corporate income, at unrelated rates.

A state tax that facially discriminates against interstate commerce is presumptively invalid under the Commerce Clause. See *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815, 1820 (1994). That facial discrimination can be removed in effect by proof of a valid "compensatory tax" designed to make interstate commerce bear the burden borne by intrastate commerce, but the compensating tax must be imposed by the state on "substantially equivalent events." 114 S. Ct. at 1821. A shareholder's owning stock and a corporation's receipt of income are *not* "substantially equivalent events." *Cf. Armco, Inc. v. Hardesty*, 467 U.S. 638, 81 L. Ed. 2d 540, *reh'g denied*, 469 U.S. 912, 83 L. Ed. 2d 222 (1984) (holding that manufacturing and wholesaling are not substantially equivalent events); *Oregon Waste Systems, Inc.*

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[4]This Court's concern with more than generalized equilibration was reflected in *Darnell* itself, when the Court described but did not reach "the most serious aspect" of the plaintiff's Commerce Clause objections: the shareholder of a foreign corporation that owned tangible property in Indiana was not allowed any reduction for the value of the corporate property taxed by Indiana. 226 U.S. at 398. The *Darnell* opinion strongly implied that the lack of such a one-to-one offset of value taxed would destroy "substantial equality." However, the opinion did not reach that issue because the plaintiff did not own stock in such a foreign corporation.

v. Department, 114 S. Ct. 1345, 128 L. Ed. 2d 13 (1994) (ruling that taxes on earning income and utilizing Oregon landfills are entirely different and non-comparable kinds of taxes).

The Supreme Court of North Carolina failed to apply the decisions of this Court specifying how clearly the compensating tax defense must be proved by the state in order to overcome a facial discrimination. This Court recently has stated that the only successful use of the compensatory tax defense in recent memory is the case of the sales and use taxes where the two taxes must involve the same rate of tax applied to equivalent bases. *Oregon Waste Systems, Inc.*, 114 S. Ct. at 1353. States impose use taxes on the cost price of goods purchased from out-of-state vendors. The use tax does not discriminate against interstate commerce when the state also charges an exactly equal sales tax on the purchase prices of goods bought in the state. *Henneford v. Silas Mason Co.*, 300 U.S. 577, 57 S. Ct. 524, 81 L. Ed. 814 (1937).

This Court most recently rejected the compensating tax defense in *Associated Indus. of Missouri v. Lohman*, 114 S. Ct. 1815, 128 L. Ed. 2d 639 (1994). Missouri sales taxes were equal to the Missouri use tax on similar purchases in 93% of the cases, and equalization of the sales and use taxes would have reduced the aggregate sales tax burden on in-state sales rather than on sales in interstate commerce. Nevertheless, due to the slightly heavier use taxation of out-of-state purchases in a minority of cases (i.e., lack of complete and easily verifiable parity of treatment) this Court rejected the compensating tax defense and ruled the Missouri tax regime to be unconstitutional. In doing so the opinion of Justice Thomas implied that "close enough for government work" is not

close enough to prove the compensating tax defense. 114 S. Ct. at 1820.

Footnote 5 of the *Lohman* opinion also warned against a court being drawn into "an amorphous inquiry that involves balancing incommensurate burdens imposed on disparate activities throughout the complex structure of a State's tax system." The North Carolina Supreme Court's decision entered into that very morass. It strained (and failed) to show nondiscrimination against interstate commerce by analyzing the state's corporate income tax and intangible property tax and by discussing price-earnings ratios and creating arguments that had not even been made by the Secretary of Revenue. It could not follow the course directed by that footnote of applying an applicable rate to substantially equivalent events because there is no common rate and there are no substantially equivalent events.

This Court should not allow state courts to roam the landscape searching for the vaguest notions of equality to justify taxes that facially discriminate against interstate commerce. Such state court opinions strip the Commerce Clause of its goal as stated in *Complete Auto Transit* to obtain a fair apportionment of taxes to each state.

The discrimination practiced by the North Carolina Secretary of Revenue rewards with lower intangible property taxation the shareholders of corporations that limit their business activities to North Carolina. This discrimination has the potential to affect the market in stocks traded in interstate commerce and to affect the

business decisions of corporations as to whether to operate outside their states of commercial domicile.[5]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 13, 1995

[5]The North Carolina Supreme Court's opinion erroneously states that commerce in corporate stocks is entitled to a lesser level of Commerce Clause protection. *Cf. Boston Stock Exchange v. State Tax Com'n*, 429 U.S. 319, 97 S. Ct. 599, 50 L. Ed. 2d 514 (1977).

[6]Fulton Corporation has no parent or subsidiary companies.

APPENDICES

APPENDIX A

IN THE SUPREME COURT OF NORTH CÁROLINA

No. 305A93 - Wake

FULTON CORPORATION

v.

BETSY Y. JUSTUS
SECRETARY OF STATE

[Filed December 9, 1994]

Appeal by plaintiff and defendant as of right pursuant to N.C.G.S. § 7A-30(1) from a unanimous decision by the Court of Appeals, 110 N.C. App. 493, 430 S.E.2d 494 (1993), reversing summary judgment for defendant, entered by Brooks, J., on 8 November 1991 in Superior Court, Wake County. This Court also allowed plaintiff's petition for discretionary review of additional issues pursuant to N.C.G.S. § 7A-31.[1] Heard in the Supreme Court 2 February 1994.

[1]Because of our resolution of the Commerce Clause issue against plaintiff's position, the additional issues raised in plaintiff's petition need not be addressed.

Womble Carlyle Sandridge & Rice, by Jasper L. Cummings, Jr., for plaintiff-appellant and -appellee.

Michael F. Easley, Attorney General, by *Marilyn R. Mudge*, Assistant Attorney General, for defendant-appellant and -appellee.

EXUM, Chief Justice

Plaintiff, Fulton Corporation, is a North Carolina corporation with its principle place of business in North Carolina. Plaintiff owns stock in other corporations and pays an "intangibles" tax on that stock to this State pursuant to N.C.G.S. § 105-203. On 1 May 1991 plaintiff filed suit challenging the constitutionality of North Carolina's intangibles tax levied on the ownership of corporate stock. Plaintiff alleged that the provisions of North Carolina's general statutes controlling the taxation of stock, particularly N.C.G.S. § 105-203, violate the Commerce Clause of the United States Constitution because the statute taxes more heavily stock of corporations not doing business in North Carolina. Plaintiff also alleged that the taxing scheme violates plaintiff's due process and equal protection rights under the North Carolina and United States Constitutions. Plaintiff requested that N.C.G.S. § 105-203 be declared null and void and that defendant be ordered to pay plaintiff a refund for the intangibles taxes paid by plaintiff for the 1990 tax year. Plaintiff and defendant both filed motions for summary judgment. The Superior Court allowed defendant's motion and denied plaintiff's motion on 15 November 1991.

Plaintiff appealed to the Court of Appeals. The Court of Appeals reversed the superior court's ruling,

holding the intangibles tax at issue violative of the Commerce Clause. The Court of Appeals, however, found that the unconstitutional provisions of the taxing scheme are severable and struck the portion of N.C.G.S. § 105-203 which reduces intangibles taxes based on the extent of business done in North Carolina by the issuing corporation. Thus, the intangibles tax on plaintiff's stock remained and plaintiff was denied a refund. Plaintiff appealed the decision of the Court of Appeals, arguing that the Court of Appeals correctly determined that the taxing scheme was unconstitutional, but that it erred in excising the deduction in N.C.G.S. § 105-203 rather than making the deduction applicable to the stock of all corporations. Defendant also appealed from the Court of Appeals' decision, arguing that N.C.G.S. § 105-203 does not violate the Commerce Clause.

We begin with an overview of North Carolina's intangible tax on corporate stock and other related tax statutes.[2] Pursuant to N.C.G.S. §§ 105-130 to 105-130.41, North Carolina imposes an income tax of 7.75%[3] on the net income of corporations doing business in North Carolina. N.C.G.S. § 105-130.3 (1992). If a corporation does business in North Carolina and other states, then only that percentage of its business income which is apportionable to North Carolina is taxable here. N.C.G.S. § 105-130.4(b) (1992). A corporation's business income is apportioned on the basis of three factors: (1) the value of

[2]Several sections in Chapter 105 were amended in the 1991 and 1992 sessions of the General Assembly. None of the amendments affect the resolution of the issues presented in this case. All references are to the most recent version of the statutes.

[3]Prior to 1991 the tax rate was 7%.

the corporation's property owned, rented or used in North Carolina during the income year divided by the value of all the corporation's property owned, rented or used during the income year; (2) the total amount paid by the corporation in North Carolina during the income year as payroll divided by the total amount paid by the corporation everywhere during the income year; and (3) the corporation's total sales in North Carolina divided by the corporation's total sales everywhere during the income year. N.C.G.S. §105-130.4(j)(1), (k)(1), (l)(1) (1992). The first factor, sales, is double-weighted in the apportionment formula. N.C.G.S. § 105-130.4(i) (1992). A multi-state corporation's nonbusiness income, such as rents, royalties, and dividends are taxed depending on whether and to what extent the income has some connection to the state. N.C.G.S. § 105-130.4(c) (1992). For example, if the property from which rents and royalties are gained, is located in North Carolina, then that non-business income is taxable in North Carolina. N.C.G.S. § 105-130.4(d)(1) (1992).

A corporation, such as plaintiff here, whose commercial domicile is in North Carolina must pay income tax on dividends received on stock which it owns. N.C.G.S. 105-130.4(f) (1992). N.C.G.S. § 105-130.7(1) provides for a deduction in the dividends on which the corporation pays tax; it states:

> [T]he Secretary of Revenue shall determine from the corporate income tax return filed during the year ending September 30 by each corporation required to file a return during that period the proportion of the entire net income or loss of the corporation allocable to this State under the provisions of G.S. 105-130(4), except as provided herein. . . . A corporation which is a stockholder in any such corporation shall be allowed to deduct the same proportion of the dividends received by it from such corporation during its income year ending on or after September 30.

The amount of deductible dividends is capped at $15,000. N.C.G.S. § 105-130.8(6). Thus, the amount of dividends a corporate shareholder may deduct is based on the percentage of the issuing corporation's net income that is allocable to and taxable in this state. The greater percentage of corporate income allocated to and taxed in this State, the more dividend income the shareholder is allowed to deduct.

N.C.G.S. § 105-203 sets forth the intangible property tax to be levied against North Carolina residents for stock owned. It states:

> All shares of stock . . . owned by residents of this State . . . shall be subject to an annual tax, which is hereby levied, of twenty-five cents (25¢) on every one hundred dollars ($100.00) of the total fair market value of the stock on December 31 of each year less the proportion of the value that is equal to:
>
> (1) In the case of a taxpayer that is a corporation, the proportion of the dividends upon the stock deductible by the taxpayer in computing its income tax liability under G.S. 105-

130.7 without regard to the fifteen thousand dollar ($15,000) limitation under G.S. 105-130.7. . . .

Thus the intangibles tax on stock is computed in the following manner; the greater the percentage of the issuing corporation's total income which is allocated to and taxed in this state the more dividend income from that corporation a corporate shareholder is allowed to deduct and the less intangibles tax the shareholder pays. The amount by which the intangibles tax against the shareholder is reduced, therefore, is directly related to the amount of the issuing corporation's income which is allocated to and taxed in this state. If 70% of the issuing corporation's income is allocated to North Carolina, then 70% of the dividends on that corporation's stock are deductible by the corporate shareholder as income, the stock's value for intangibles tax purposes is reduced by 70%, and the intangibles tax thereby decreased by 70%.

We now turn to the issue before us, which is whether North Carolina's intangibles tax on stock violates the Commerce Clause.

The United States Constitution grants Congress the authority to "regulate Commerce . . . among the several states." U.S. Const. art. II, § 8, cl. 3. It is well established that "[t]he Commerce Clause was not merely an authorization to Congress to enact laws for the protection and encouragement of commerce among the States, but by its own force created an area of trade free from interference by the States." *Freeman v. Hewit*, 329 U.S. 249, 252, 91 L. Ed. 265, 271 (1946), *reh'g denied*, 329 U.S. 832, 91 L. Ed. 705 (1947). Pursuant to the Commerce Clause no state may "impose a tax which discriminates

against interstate commerce . . . by providing a direct commercial advantage to local businesses." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458, 3 L. Ed. 2d 421, 427 (1959). It is the Court's "'duty to determine whether the statute under attack, whatever its name may be, will, in its practical operation work discrimination against interstate commerce.'" *Maryland v. Louisiana*, 451 U.S. 725, 756, 68 L. Ed. 2d 576, 601 (1981) (quoting *Best & Co. v. Maxwell*, 311 U.S. 454, 455-56, 85 L. Ed. 275, 277 (1940)).

Even a discriminatory tax, however, will be upheld where it is "designed simply to make interstate commerce bear a burden already born by intrastate commerce." *Associated Indus. of Missouri v. Lohman*, 511 U.S. ____, ____, 128 L. Ed. 2d 639, 647 (1994). "Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the . . . Commerce Clause." *Oregon Waste Sys., Inc. v. Department of Environmental Quality*, 511 U.S. ____, ____, 128 L. Ed. 2d 13, 23 (1994). "The common thread running through the cases upholding compensatory taxes is the equality of treatment between local and interstate commerce." *Maryland v. Louisiana*, 451 U. S. at 759, 68 L. Ed. 2d at 603.

Plaintiff argues that the intangibles tax on stock is facially discriminatory against corporations doing business outside North Carolina. Plaintiff asserts that due to the greater taxation of stock of corporations doing business outside North Carolina, those corporations will have more difficulty raising capital through the sale of stock in North Carolina than will corporations doing business in North Carolina only. Plaintiff also asserts that the current tax

scheme encourages corporations to conduct business in North Carolina since that will reduce the intangibles tax liability to its North Carolina shareholders thereby enhancing the marketability of its shares in North Carolina.

Defendant argues that there is no evidence in the record showing that the tax scheme will actually affect interstate commerce. Defendant also argues that this case is controlled by *Darnell v. Indiana*, 226 U.S. 390, 57 L. Ed. 267 (1912), and that any discrimination in the tax scheme can be justified as a compensatory tax.

After carefully reviewing the Supreme Court's jurisprudence in this area of law, which the Court itself has characterized as a "quagmire," *American Trucking Ass'n v. Scheiner*, 483 U.S. 266, 280, 97 L. Ed. 2d 226, 241 (1987), we conclude that the tax in question is permissible based on the Court's holding in *Darnell*.

In *Darnell* the plaintiff, a resident of Indiana, owned stock in a Tennessee corporation which paid no property taxes in Indiana. Indiana taxed all shares in foreign corporations owned by inhabitants of the state, and "all shares in domestic corporations when the property of the corporations . . . is not taxable to the corporation itself. If the value of the stock exceeds that of the tangible taxable property that excess also is taxed." *Darnell* at 397, 57 L. Ed. at 272. The plaintiff challenged the Indiana intangibles tax on the ground that it violated the Commerce Clause and the Fourteenth Amendment. The Court upheld the tax in an opinion by Justice Holmes, who reasoned:

> The only difference of treatment disclosed by the record that concerns the defendants, is that the State taxes the property of domestic corporations and the stock of foreign ones in similar cases. That this is consistent with substantial equality not-withstanding the technical differences was decided in *Kidd v. Alabama*, 188 U.S. 730, 732, 47 L. Ed. 669, 672, 23 Sup. Ct. Rep. 401.[4]

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[4]In *Kidd v. Alabama*, 188 U.S. 730, 47 L. Ed. 669 (1903), an Alabama tax on the stock of foreign railroads was challenged because there was no corresponding tax on the stock of domestic railroads. The Court upheld the tax against a challenge that the tax violated the Fourteenth Amendment, stating:

> We see nothing to prevent a state from taxing stock in some domestic corporations and leaving stock in others untaxed on the ground that it taxes the property and franchises of the latter to an amount that imposes indirectly a proportional burden on the stock. When we come to corporations formed and having their property and business elsewhere, the state must tax the stock held within the state if it is to tax anything and we are now assuming the right to tax stock in foreign corporations to be conceded. If it does tax that stock, it may take into account that the property and franchise of the corporation are untaxed on the same ground that it might do the same thing with a domestic corporation. There is no rule that the state cannot look behind the present net value of different stocks.

The Court reasoned similarly in *Klein v. Board of Tax Supervisors of Jefferson County, KY.*, 282 U.S. 19, 75 L. Ed. 140 (1930). In Klein the plaintiff raised a Fourteenth Amendment challenge to a Kentucky tax on stock which exempted stock in corporations which

We find our case controlled by *Darnell*. In *Darnell* the Supreme Court found substantial equality, sufficient to satisfy the Commerce Clause, in taxing the stock of foreign corporations not paying property taxes and taxing the property of domestic corporations.[5] In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed

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had 75% of their total property in Kentucky and paid Kentucky property taxes on the property. The Court affirmed the tax, stating:

> If the corporation having all its property in the state had paid taxes upon the whole, usually it would be just not to tax the stockholder in respect of values derived from what has already borne its share.

Id. at 23, 75 L. Ed. at 142-43.

While *Kidd* and *Klein* involved challenges to taxes based upon the Fourteenth Amendment, which makes those cases distinguishable from the challenge before us based on the Commerce Clause, they are nevertheless persuasive authority for the proposition that a state may tax the shares of certain corporations, such as a corporation doing business outside North Carolina, and with respect to other corporations, such as corporations operating exclusively in the state, tax the corporation itself, whether it be a property tax or an income tax.

[5]The Indiana statute actually taxed all foreign corporations regardless of whether they actually paid property taxes in Indiana. The plaintiffs in *Darnell*, however, did not establish that their corporations paid Indiana property taxes and the Supreme Court limited its holding to situations where the corporation in question paid no property tax in Indiana.
Darnell, 226 U.S. at 398, 57 L. Ed. at 272.

in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of "compensating" tax scheme the Supreme Court upheld in *Darnell*.

Plaintiff attempts to distinguish *Darnell* on the ground that "[u]nlike the instant case *Darnell* dealt with a property tax on the shareholder that was directly offset by the property tax on the corporation." We agree with plaintiff that the instant case does not involve an intangibles tax to the shareholder which is offset by a *property* tax to the corporation, but we find that difference immaterial. This case involves a reduction in the intangibles tax to the shareholder which is offset in a direct proportional way by an *income* tax to the corporation.

Where a corporation does business inside and outside North Carolina, it pays income tax to North Carolina on only that portion of its income allocable to North Carolina under N.C.G.S. § 105-130.4. A corporation doing business solely in North Carolina pays an income tax on all of its income. The North Carolina income tax paid by a corporation doing business solely in North Carolina will therefore be greater than the North Carolina income tax of similar corporation doing some business outside North Carolina. This excess income tax paid by the North Carolina corporation offsets, or balances, the intangible property tax on stock of the corporations doing some business outside North Carolina in the same manner that the property tax paid by domestic corporations in *Darnell* offset the intangible property tax on shares of stock of foreign corporations which did not pay property taxes in Indiana.

Plaintiff further attempts to distinguish *Darnell* on the ground that while there might be a relationship between the value of a corporation's stock and the value of its property, the "relationship between the stock-issuing corporation's North Carolina income tax and the shareholders' North Carolina intangible property tax" is "vague." We disagree.

Corporate income tax, which is directly proportional to corporate income, affects the amount of corporate income available for distribution as dividends to shareholders, and dividends paid are a major component of the valuation of the corporation's stock. Hence, we think it a sound generalization that corporate income, and income tax paid, are strongly related to the value of the corporation's stock. The strength of this relationship is aptly demonstrated by the fact that economists and investors frequently make use of the "price-earnings" ratio, or P/E ratio, which essentially represents the relationship of the value of a corporation's stock to its earnings. *See, e.g.,* 3 The New Palgrave Dictionary of Money & Finance 176 (1992).[6]

Plaintiff also asserts that even if a corporation's income bears a relationship to the value of its stock, taxation of corporate income and taxation of corporate shares do not necessarily result in equal treatment. Plaintiff provides the following hypothetical situation:

[6]The P/E ratio usually refers to price per share, but that ratio is the same as the value of all corporate stock, which is price per share times number of shares outstanding, to the corporations' earnings, which is earnings per share times number of shares outstanding.

> Corp. X, operating solely in North Carolina, earns $100 income from unproductive real estate worth $1 million. It pays about $7 North Carolina income tax and its shareholders pay zero intangible tax. Corp. Y, an identical corporation operating solely in Virginia, pays no North Carolina income tax and its shareholders pay $2,500 intangible tax on $1 million in stock value.

We agree that in this hypothetical situation the intangibles tax on shares of a foreign corporation greatly exceeds the income tax to a similar corporation operating solely in North Carolina. Only in exceptional and extreme cases, such as the one suggested by plaintiff, would North Carolina's tax against shares of corporations doing business in other states exceed the tax against the income of similar corporations doing business in North Carolina.

North Carolina taxes corporate income at 7.75 percent and taxes ownership of stock at .25 percent of the taxable value of the stock. Given these tax rates, a North Carolina corporation need only have a P/E ratio less than 31 (7.75/.25) in order to have the tax against its income exceed the intangibles tax against the stockholders of a comparable corporation doing business only in Virginia and having all its shareholders in North Carolina.[7] Since

[7]With the P/E ratio of 31, stock valued at $3100 earns $100 of income to the corporation. If the corporation conducted no business in North Carolina, the intangibles tax against the shareholders would be .0025 x $3100, or $7.75; if the corporation conducted all of its business in North Carolina, then the income tax against the corporation would be .0775 x $100, or $7.75.

P//E ratios are only rarely greater than 31,[8] most out-of-state corporations will in fact be paying less taxes to North Carolina, directly in the form of an income tax and indirectly in the form of an intangibles tax against shares, than a similar North Carolina corporation. The result reached in plaintiff's hypothetical situation above seems to unfairly tax out-of-state corporations, but that hypothetical involves the unrealistic situation of a corporation with P/E ratio of 10,000. The absurdity of plaintiff's hypothetical demonstrates that under ordinary circumstances there will be no greater taxation of out-of-state corporations and their shareholders than there will be in-state corporations and their shareholders.

While there are some differences between the tax and issue here and the one in *Darnell*, we find these differences not material and we believe that North Carolina's intangibles tax on corporate stock, when considered with its corporate income tax, provides for "substantial equality" as was found in *Darnell*.

We also feel it necessary briefly to address the continued validity of *Darnell*. While plaintiff's principle argument regarding *Darnell* is that it is distinguishable, which we have rejected, it also argues to a lesser degree that *Darnell* has been implicitly overruled or modified by more recent cases. The principal modern cases discussing the compensating tax and cited by plaintiff are *Armco v. Hardesty*, 467 U.S. 638, 81 L. Ed. 2d 540, *reh'g denied*, 467

[8] *See, e.g.*, 3 The New Palgrave Dictionary of Money & Finance at 177 (showing Standard & Poor's Composite Index for P/E ratio from 1926 to 1991; P/E ratio mainly between 10 and 20, never greater than 25).

U.S. 638, 81 L. Ed. 2d 540 (1984) and *Maryland v. Louisiana*, 451 U.S. 725, 68 L. Ed. 2d 576 (1981).

In *Armco* West Virginia imposed a gross receipts tax on wholesale sales of tangible property; local manufacturers, however, were exempt from this tax. 467 U.S. at 640, 81 L. Ed. 2d at 5-6. The plaintiff, an Ohio corporation selling steel products wholesale in West Virginia, challenged the wholesale tax. *Id.* The Court first determined that the tax was facially discriminatory against interstate commerce and then proceeded to examine whether the tax could be saved as a compensating tax. 467 U.S. at 642, 81 L. Ed. 2d at 545. West Virginia argued that the wholesale tax exempting local manufacturers was designed to offset a sales tax imposed against local manufacturers only. The Court rejected that argument, reasoning that manufacturing and wholesaling are not "substantially equivalent events" and that certain aspects of the West Virginia sales tax on manufacturers indicated that the tax was aimed at manufacturing and not wholesaling.[9] *Id.* at 643, 81 L. Ed. 2d at 545-46.

In *Maryland v. Louisiana* the Court faced a Louisiana tax on the "first use" of gas; the tax, however, did not apply to gas extracted from Louisiana, which was subject to a "severance tax" equal to the first use tax, and did not apply to gas sold in Louisiana for certain purposes. 451 U.S. at 731, 68 L. Ed. 2d at 586. The Court first determined that the tax "discriminate[d] against interstate

[9] The aspects of the West Virginia taxing scheme the Court looked to were that West Virginia did not reduce the manufacturing tax when the goods were sold outside West Virginia and that the manufacturing tax was decreased when part of the manufacturing occurred outside the state. *Armco*, 467 U.S. at 643, 81 L. Ed. 2d 546.

commerce in favor of local interests." *Id.* at 756, 68 L. Ed. 2d at 602. The Court then dealt with Louisiana's argument that the first use tax was equalized by the severance tax which affected only local producers of gas. The Court rejected the argument, finding that the rationale behind the severance tax, which is a tax on the privilege of severing resources from the soil, does not exist with respect to gas not extracted from Louisiana. *Id.* at 759, 68 L. Ed. 2d at 603.

After reviewing these cases, we believe we should not conclude that *Darnell* has been implicitly overruled. First, we generally are loath to conclude that a Supreme Court decision has been implicitly overruled, especially when the Court has emphasized that issues involved here must be decided on a case-by-case basis. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329, 50 L. Ed. 2d 514, 524 (1977) (whether law violates Commerce Clause "turns on the unique characteristics of the statute at issue and the particular circumstances in each case"). The Supreme Court of Indiana unanimously reached the same conclusion in *Indiana Department of State Revenue v. Felix*, 571, N.E.2d 287, 292 (1991), *cert. dismissed*, ___ U.S. ___, 117 L. Ed. 2d 278 (1992) (after thorough analysis, court could not "conclude that *Darnell* has been implicitly overruled by the United States Supreme Court").

We are also reluctant to conclude that *Darnell* has been overruled by *Armco* and *Maryland v. Louisiana* because the taxes at issue in those cases are readily distinguishable. *Armco* and *Maryland v. Louisiana* dealt with taxes on the interstate exchange of goods, namely steel products and gas; this case, however, concerns a tax which allegedly discriminates against the interstate ownership of corporate shares. Since a corporation's

continued existence and success depend most heavily on its ability to market its goods, a discriminatory tax levied upon a corporation's trade may well come under closer Commerce Clause scrutiny than a tax on the stock it issues. The latter has no effect on the corporation's trade and, we think a negligible effect on a multi-state corporation's ability to raise capital.

Thus, as this case is controlled by *Darnell*, which has not been overruled, we rule in favor of defendant and conclude that the tax is valid. Finding the tax valid, we do not reach plaintiff's questions regarding a refund and attorney's fees.

Plaintiff also argues in its brief that the tax is unconstitutional under other provisions of the state and federal constitutions. No reference was made to bringing this argument before the Supreme Court in plaintiff's notice of appeal, petition for discretionary review or response to defendant's notice of appeal. Plaintiff has not discussed those arguments in its new brief filed with us. Therefore, we conclude that this issue is not properly before this Court. N.C.R. App. P. 16(a) & 28(a).

The decision of the Court of Appeals is, therefore, reversed and the judgment of the Superior Court reinstated.

REVERSED AND REMANDED.

APPENDIX B

IN THE COURT OF APPEALS

FULTON CORP. v. JUSTUS

[110 N.C. App. 493 (1993)]

FULTON CORPORATION, PLAINTIFF
v.
BETSY Y. JUSTUS, SECRETARY OF REVENUE, DEFENDANT

No. 9210SC15

(Filed 15 June 1993)

Appeal by plaintiff from judgment entered 8 November 1991 by Judge Dexter Brooks in Wake County Superior Court. Heard in the Court of Appeals 8 December 1992.

Womble Carlyle Sandridge & Rice, by Jasper L. Cummings, Jr., for plaintiff appellant.

Attorney General Lacy H. Thornburg, by Assistant Attorney General Marilyn R. Mudge, for defendant appellee.

COZORT, Judge.

Plaintiff filed suit challenging the constitutionality of North Carolina's intangibles tax levied on ownership of corporate stock. Plaintiff contends the provisions violates the Commerce Clause of the United States Constitution by increasing the tax liability for shares of stock of corporations which have business activities, property locations, and tax liabilities outside of North Carolina; and by lessening the tax liability for shares in corporations whose business and property are largely or completely in North Carolina. The superior court granted summary judgment for the defendant Secretary of Revenue. We find the taxing scheme violates the Commerce Clause, and we reverse. We further find that the provisions of the taxing scheme are severable, and we strike the portion of N.C. Gen. Stat. § 105-203 which gives a reduction in intangibles tax liability under the taxable percentage provision.

We begin with an overview of North Carolina's intangibles tax on corporate stock and other related tax statutes. (Several sections in Chapter 105 were amended in the 1991 and 1992 sessions of the General Assembly. None of the amendments affect the resolution of the issues presented in this case. For convenience to the reader, all references are to the most recent version of the statutes.) Pursuant to N.C. Gen. Stat. §§ 105-130 through 105-130.41 (1992), North Carolina imposes an income tax on corporations doing business in North Carolina. If a corporation does business only in North Carolina, then one hundred percent of the corporation's business income is taxed in North Carolina. N.C. Gen. Stat. § 105-130.3 (1992). If a corporations does business in North Carolina and other states, then only that percentage of business income apportioned to North Carolina is taxable here. N.C. Gen. Stat. § 105-130.4(b) (1992). A corporation's

business income is apportioned on the basis of three factors: (1) the corporation's total sales in North Carolina divided by the corporation's total sales everywhere during the income year; (2) the value of the corporation's property owned, rented or used in North Carolina during the income year divided by the value of all the corporation's property owned, rented or used during the income year; and (3) the total amount paid by the corporation in North Carolina during the income year as compensation divided by the total amount paid by the corporation everywhere during the income year. N.C. Gen. Stat. § 105-130.4(i) through (1)(3). The first factor, sales, is double-weighted in the apportionment formula. *Id.* A multistate corporation's nonbusiness income, such as rents, royalties, interest, and gains and losses, is subject to North Carolina income tax if the income has some connection to the state; for example, North Carolina is the corporation's principal place of business or the situs of the non-business activities or investments. N.C. Gen. Stat. § 105-130.4(c)-(h) (1992).

Pursuant to N.C. Gen. Stat. § 105-217 (1992), North Carolina imposes an intangibles tax on accounts receivable; bonds, notes, and other evidences of debt; beneficial or equitable interests in foreign trusts; and shares of stock. N.C. Gen. Stat. § 105-203 (1992) provides in pertinent part:

> All shares of stock . . . owned by residents of this State . . . shall be subject to an annual tax, which is hereby levied, of twenty-five cents (25¢) on every one hundred dollars ($100.00) of the total fair market value of the stock on December 31 of each year less the proportion of the value that is equal to:

> (1) [T]he proportion of the dividends upon the stock deductible by the taxpayer in computing its income tax liability under G.S. 105-130.7 without regard to the fifteen thousand dollar ($15,000) limitation under G.S. 105-130.7. . . .

The provision beginning with "less the proportion of the value" is commonly referred to as the taxable percentage provision, which is the subject of plaintiff's challenge.

Under the tax scheme, if a corporation does no business in North Carolina and has no taxable income here, then the taxable percentage of a shareholder's stock is one hundred percent. If a multistate corporation does business in North Carolina and earns business and/or nonbusiness income subject to North Carolina income tax, then the taxable percent of a shareholder's stock is the inverse of the issuing corporation's net taxable income in North Carolina. The tax is collected by the state, made part of the General Fund, and is available for appropriation to the taxpayer's resident county. N.C. Gen. Stat. § 105-213.1 (1992).

Plaintiff is a North Carolina corporation which, as of 31 December 1990, held stock in six corporations. Of the six corporations, only Food Lion, a multistate corporation, conducted business in North Carolina. Since forty-six percent of Food Lion's net income was subject to North Carolina corporate income tax for the 1990 taxable period, the taxable percentage of plaintiff's stock in Food Lion was fifty-four percent. The taxable percentage of plaintiff's stock in the remaining five corporations was one hundred percent. On 8 January 1991, plaintiff filed an intangible personal property tax return and remitted

$10,884.00. On 1 May 1991, plaintiff filed suit in Wake County Superior Court seeking a refund of the $10,884.00 paid in intangible tax, a declaratory judgment that N.C. Gen. Stat. § 105-203 is unconstitutional, and attorneys' fees. Both parties moved for summary judgment. Judge Dexter Brooks granted summary judgment for the Secretary of Revenue.

On appeal, plaintiff argues that the trial court erred in granting summary judgment because the intangibles tax (1) violates the Commerce Clause of the United States Constitution, and (2) violates the Due Process and Equal Protection Clauses of the United States and North Carolina Constitutions. Plaintiff further argues that the trial court erred in denying relief pursuant to 42 U.S.C.S. § 1983 and attorneys' fees pursuant to 42 U.S.C.S. § 1988.

[1] We first consider whether plaintiff-taxpayer has standing to challenge the constitutionality of the statute. In North Carolina, a taxpayer has standing to challenge a tax if "'the tax levied upon him is for an unconstitutional . . . purpose, . . . the carrying out of all the challenged provisions "will cause him to sustain personally, a direct and irreparable injury," or [if] he is a member of the class prejudiced by the operation of the statute . . . .'" *Orange County v. N.C. Dept. of Transportation*, 46 N.C. App. 350, 361, 265 S.E.2d 890, 899, *disc. review denied*, 301 N.C. 94 (1980)(citations omitted). The United States Supreme Court has recognized, at lease implicitly, that a local taxpayer has standing to challenge a tax on the grounds that the tax violates the Commerce Clause. *See Goldberg v. Sweet*, 488 U.S. 252, 261, 102 L. Ed. 2d 607, 617 (1989); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 10 L. Ed. 2d 202, *reh'g denied*, 374 U.S. 858, 10 L. Ed. 2d 1082 (1963); *I.M. Darnell & Son Co. v. Memphis*, 208 U.S.

113, 52 L. Ed. 413 (1908); *Walling v. Michigan*, 116 U.S. 446, 29 L. Ed. 691 (1886). We thus find plaintiff has standing to challenge the taxing provisions.

[2] Next, we consider plaintiff's argument that North Carolina's intangibles tax violates the Commerce Clause of the United States Constitution. U.S. Const. art. I, § 8, cl. 3 confers upon Congress the power "[t]o regulate commerce with foreign nations, and among the several states, and with the Indian tribes." Plaintiff argues: (1) that the discrimination appears on the face of the statute; (2) that the tax indirectly discriminates against out-of-state business; and (3) that the compensating tax defense is not available to save the tax. Plaintiff summarizes the discrimination as follows: The more a corporation's business and property are located in North Carolina, the higher is the percentage of its income subject to taxation in this state, and the higher is the percentage of its stock not subject to the intangibles tax. The more a corporation's business and property are located out-of state, the higher is the percentage of its stock subject to the intangibles tax. Therefore, the tax scheme favors corporations that operate totally or more in North Carolina and disfavors corporations that operate totally or more in other states. Plaintiff cites two possible impacts on interstate commerce. First, plaintiff allege the tax encourages investors to buy stock in local corporations, thereby possibly affecting the ability of out-of-state corporations to raise capital in North Carolina, thus lessening the trading of stocks in interstate commerce. Second, plaintiff alleges local corporations may be encouraged not to enter interstate commerce in order to avoid the intangibles taxation for their shareholders.

To survive constitutional challenge under the Commerce Clause, a tax must (1) apply to an activity with a substantial nexus with the taxing state, (2) be fairly apportioned, (3) be fairly related to the services provided by the state, and (4) not discriminate against interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L. Ed. 2d 326, 331, *reh'g denied*, 430 U.S. 976, 52 L. Ed. 2d 371 (1977). At issue here is the fourth requirement. It is fundamental that "[n]o State may, consistent with the Commerce Clause, 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'" *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329, 50 L. Ed. 2d 514, 524 (1977)(quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458, 3 L. Ed. 2d 421, 427 (1959)). "A State may no more use discriminatory taxes to assure that nonresidents direct their commerce to businesses within the State than to assure that residents trade only in intrastate commerce." *Id.* at 334-35, 50 L. Ed. 2d at 527. "Whether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere, it is still a discriminatory tax that 'forecloses tax-neutral decisions and . . . creates . . . an advantage' for firms operating in [the State] by placing 'a discriminatory burden on commerce to its sister States.'" *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 406, 80 L. Ed. 2d 388, 402 (1984)(quoting *Boston Stock Exchange*, 429 U.S. at 331, 50 L. Ed. 2d at 525).

Discrimination may appear on the face of the statute or in its practical operation. "When a tax, on its face, is designed to have discriminatory economic effects, the Court 'need not know how unequal the Tax is before concluding that it unconstitutionally discriminates.'" *Id.* at 406-07, 80 L. Ed. 2d at 403 (quoting *Maryland v.*

Louisiana, 451 U.S. 725, 760, 68 L. Ed. 2d 576, 604 (1981)). "Once a state tax is found to discriminate against out-of-state commerce, it is typically struck down without further inquiry." *Chemical Waste Management v. Hunt*, 504 U.S. ---, 119 L. Ed. 2d 121, 132 (1992). "[W]here discrimination is patent, . . . neither a widespread advantage to in-state interests nor a widespread disadvantage to out-of-state competitors need be shown." *New Energy Co. v. Limbach*, 486 U.S. 269, 276, 100 L. Ed. 2d 302, 310 (1988).

"[A] State may validate a statute that discriminates against interstate commerce by showing that it advances a legitimate local purpose that cannot be adequately served by reasonable non-discriminatory alternatives." *Id.* at 278, 100 L. Ed. 2d at 311. A state may also validate a facially discriminatory tax by showing that the tax is a compensatory tax. A tax may be considered a compensating tax when "[the] State is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials to be consumed in the State." *Maryland v. Louisiana*, 451 U.S. at 759, 68 L. Ed. 2d at 603; *see also Ashland Oil, Inc. v. Caryl*, 497 U.S. 916, 111 L. Ed. 2d 734 (1990).

Applying these principles to North Carolina's intangibles taxing scheme, we find that the tax facially discriminates against interstate commerce. Shareholders of out-of-state corporations are required to pay intangibles taxes on a higher percentage of shares than shareholders of corporations operating solely in North Carolina. We further find that the facially discriminatory tax indirectly encourages the development of local business by placing a greater burden on economic activities occurring outside North Carolina than is placed on similar activities within

North Carolina. The tax forecloses tax-neutral decisions and creates an advantage for firms operating in North Carolina. *See Westinghouse,* 466 U.S. at 406, 80 L. Ed. 2d at 402.

[3] We next consider whether the discriminatory effect of the tax is counterbalanced by a compensating tax. We must determine if the State is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials to be consumed in the State. In *Armco, Inc. v. Hardesty,* 467 U.S. 638, 81 L. Ed. 2d 540, *reh'g denied,* 469 U.S. 912, 83 L. Ed. 2d 222 (1984), the United States Supreme Court addressed the constitutionality of West Virginia's business and operation tax. There, plaintiff, an Ohio corporation engaged in the business of manufacturing and selling steel products in West Virginia, challenged on Commerce Clause grounds the constitutionality of West Virginia's tax requiring persons engaged in the business of selling tangible property at wholesale to pay taxes on gross receipts. Local manufacturers were exempt from the gross receipts tax; however, they were required to pay a higher manufacturing tax. The United States Supreme Court found the tax unconstitutional, rejecting West Virginia's argument that the higher manufacturing tax was a compensating tax for the gross receipt tax. The Court held:

> [M]anufacturing and wholesaling are not "substantially equivalent events" such that the heavy tax on in-state manufacturers can be said to compensate for the admittedly lighter burden placed on wholesalers from out of State. Manufacturing frequently entails selling in the State, but we cannot say which portion of the manufacturing tax is attributable to manufacturing and with portion to sales. The fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State, and that it is reduced when part of the manufacturing takes place out of State, makes clear that the manufacturing tax is just that, and not in part a proxy for the gross receipts tax imposed on Armco and other sellers from other States.

Id. at 643, 81 L. Ed. 2d at 545-46. The Court further reasoned that there was discrimination against interstate commerce when the two taxes were considered together: "If Ohio or any of the other 48 States imposes a like tax on its manufacturers -- which they have every right to do -- then Armco and others from out of State will pay both a manufacturing tax and a wholesale tax while sellers resident in West Virginia will pay only the manufacturing tax." *Id.* at 644, 81 L. Ed. 2d at 546. Finally, the Court rejected West Virginia's argument that Armco had to prove actual discriminatory impact by naming a state that imposes a manufacturing tax resulting in a tax burden higher than that imposed on Armco's competitors in West Virginia. Rather, the test is whether the facially discriminatory tax is internally consistent such that "'if applied by every jurisdiction' there would be no impermissible interference with free trade." *Id.*

The Secretary of Revenue argues here that taxing shareholders on the proportion of their stock values equivalent to the percentage of the issuing corporation's income taxed outside the state compensates for the state's inability to tax the corporation's out-of-state property and the income it generates. We disagree. We find the Court's reasoning in *Armco* applicable to this case. We

note first that there is only a vague relationship between property taxes paid by a corporation to governmental entities in North Carolina and intangibles property tax paid by its shareholders on the corporation stock. As plaintiff points out, under the tax scheme a corporation could pay no property taxes in North Carolina, and the taxable percentage of its stock still be less than one hundred percent because the taxable percentage is computed by multiplying *three* factors: sales, payroll, and property. Second, the "compensating tax" is levied upon the shareholder, a taxpayer different from the corporation. If a corporation owns no property in North Carolina, the state has no burden of providing protection to the corporation's property and should not be allowed to tax the corporation's stock as proxy for the corporate property. We find no substantially equivalent event justifying the imposition of the intangibles tax at a higher percentage on the stock of out-of-state corporations than in-state corporations. We thus reject the Secretary's argument on compensating tax.

The Secretary further argues that *Darnell v. State*, 174 Ind. 143, 90 N.E. 769 (1910), *aff'd, Darnell v. Indiana*, 226 U.S. 390, 57 L. Ed. 267 (1912), is dispositive of plaintiff's appeal. In *Darnell*, Indiana sought to collect taxes on stock of a Tennessee corporation owned by an Indiana resident. Under the Indiana statute, the state could levy taxes on all shares in a foreign corporation, except national banks, owned by state residents, and all shares in a domestic corporation owned by state residents when the property of the corporations was not exempt or not taxable to the corporation itself. *Id.* at 397-98, 57 L. Ed. at 272. The value of the stock exceeding the value of the tangible taxable property was also taxable. Plaintiff argued to the Indiana Supreme Court that the tax

discriminated "in favor of domestic stocks as against shares in a foreign corporation, and that a resident owning stock in a domestic corporation escapes taxation thereon, while his next-door neighbor owning shares of stock in a foreign corporation is required to pay taxes on his holdings." *Darnell v. State*, 174 Ind. at 153-54, 90 N.E. at 773. The Indiana Supreme Court upheld the tax, finding that the purpose of the tax was "to require all property to contribute pro rata its share of taxes, and so far as practicable to avoid double taxation." *Id.* at 156, 90 N.E. at 774. The Indiana Supreme Court stated:

> Domestic corporations are taxed upon all their property: . . . The state, in its discretion, might tax the shares of stock in such corporation to the individual owners thereof residing in this state, but it would in a sense be double taxation, and it has not been the policy of this state to do so. Shares of stock in a foreign corporation doing business in another state owned and held by a resident of this state are taxed because they have not been and cannot be otherwise taxed by this state. If a corporation organized in this state is engaged in business in another state, and all its tangible property is outside this state, then its shares of stock owned by residents within this state are taxable in the same manner as stock in a foreign corporation. The fact that the state in which the corporate property may be situated taxes such tangible property in no wise affects the right of this state to tax its own inhabitants upon all their personal property including shares of stock in such foreign corporation. The man who resides in one state and enjoys the benefit of its schools, churches, society, highways, and other public

accommodations, as well as its governmental protection over his person and property, is in no position to complain when required to contribute by taxation ratably upon his property for the maintenance of these institutions and the local government. It is clear to our minds that the tax law of Indiana is not open to the charge of discrimination against stock in foreign corporations, but imposes only just and equal burdens upon all corporate stocks without regard to the place of incorporating or of conducting the corporate business, and does not violate either the third clause of section 8, art. 1, or the fourteenth amendment to the Constitution of the United States, and is accordingly valid.

Id. at 156-57, 90 N.E. at 774 (citations omitted). The United States Supreme Court affirmed with Justice Holmes writing:

> The case is pretty nearly disposed of by Kidd v. Alabama, 188 U.S. 730, 47 L. Ed. 669, 23 Sup. Ct. Rep. 401, where the real matter of complaint, that the property of the corporation presumably is taxed in Tennessee, is answered. But it is said that the former decision does not deal with the objection that the statutes work a discrimination against stock in corporations of other states, contrary to principles often recognized. The most serious aspect of this objection is that the statutes of Indiana do not make allowance if a foreign corporation has property taxed within the state. But, as to this, it is enough to say that, however the statues may be construed in a case of that sort, the plaintiffs in error do not show that it is theirs, and that, as they do not belong to the class for whose sake the constitutional protection would be given, if it would, they cannot complain on that ground . . . .
>
> The only different on treatment disclosed by the record that concerns the defendants is that the state taxes the property of domestic corporations and the stock of foreign ones in similar cases. That this is consistent with substantial equality notwithstanding the technical differences was decided in Kidd v. Alabama, 188 U.S. 730, 732, 47 L. Ed. 669, 672, 23 Sup. Ct. Rep. 401.

Darnell v. Indiana, 226 U.S. at 397-98, 57 L. Ed. at 272 (citations omitted).

We find *Darnell* distinguishable. Under the 1912 Indiana tax scheme, to the extent that a corporation paid property taxes to Indiana, the corporation's shareholders were exempt from paying taxes on the identical value of property already taxed to the corporation. As noted by the Indiana Supreme Court, the purpose of the tax was to "require all property to contribute pro rata its share of taxes, and so far as practicable to avoid double taxation." *Darnell*, 174 Ind. at 156, 90 N.E. at 774. Under the North Carolina scheme, corporate stock is not viewed as embodying the very same real and personal property owned by the corporation. Unlike the Indiana scheme, there is no effort to tax corporate property only once, to the extent its value is represented in the stock value. There is no one-to-one correlation between *property* tax paid by the corporation and taxes paid by the shareholder on shares owned. There is, however, a correlation between *income* taxed to the corporation and the property

(shares) of the shareholder. In determining the amount of business income to be taxed to the corporation, the amount of corporate property located in North Carolina is only one of three unequally weighted factors: sales, payroll, and property. *See* N.C. Gen. Stat. § 105-130.4(i) through (1)(3). Since the sales factor is double weighted, the property factor accounts for only one-fourth of the apportionment formula. *See* N.C. Gen. Stat. § 105-130.4(i). We note further that North Carolina has largely abandoned its efforts to avoid double taxation of corporate income. For example, under the scheme for taxing dividends, corporate income in the form of dividends is subject to double taxation. *See* N.C. Gen. Stat. §§ 105-130.7(1) and 105-151.19 (1992). We conclude that the difference in the 1912 Indiana tax scheme and the present North Carolina tax scheme is significant, such that *Darnell* is not dispositive of plaintiff's appeal.

[4] Having found the intangibles taxing scheme to be unconstitutional, we now must determine the proper remedy. Plaintiff argues that the entire tax must be stricken. The Secretary argues that we must enforce the Intangibles Tax Article's severability clause, thus excising the phrasing which reduces the intangibles tax on corporate stock of totally or partially North Carolina corporations. We find the Secretary's argument persuasive. N.C. Gen. Stat. § 105-215 (1992) provides:

> If any clause, sentence, paragraph, or part of this [Intangible Personal Property Tax] Article or schedule shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this Article or schedule, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment shall have been rendered.

Accordingly, we find that we must excise from N.C. Gen. Stat. § 105-203 this language:

> [L]ess the proportion of the value that is equal to:
>
> (1) In the case of a taxpayer that is a corporation, the proportion of the dividends upon the stock deductible by the taxpayer in computing its income tax liability under G.S. 105-130.7 without regard to the fifteen thousand dollar ($15,000) limitation under G.S. 105-130.7 . . . .

As rewritten, the statute levies an intangibles tax upon "[a]ll shares of stock . . . owned by residents of this State . . . ."

Plaintiff, a resident owner of stock, is subject to the tax and not entitled to a refund. Both the United States Supreme Court and North Carolina Supreme Court have "recognized that in some cases it would be inequitable to apply newly announced rules retroactively if prior to the enunciation of the rules parties had reasonably relied on certain principles in ordering their affairs. In such a case the rule is not applied retroactively." *Swanson v. State of N.C.*, 329 N.C. 576, 581, 407 S.E.2d 791, 793 (1991). Accordingly, we find retroactive application of the revised statute inequitable and therefore order the revised statute to apply prospectively to the 1994 tax year.

We further find that plaintiff is not entitled to relief under 42 U.S.C.S. § 1983. A party may bring suit against state officials pursuant to 42 U.S.C.S. § 1983 for violations of the Commerce Clause. *Dennis v. Higgins*, 498 U.S. 439, 112 L. Ed. 2d 969 (1991). "[W]hen an action is brought under section 1983 in state court against the State, its agencies, and/or its officials acting in their official capacities, neither a State nor its officials acting in their official capacities are 'persons' under section 1983 when the remedy sought is monetary damages." *Corum v. University of North Carolina*, 330 N.C. 761, 771, 413 S.E.2d 276, 282-83 (1992). "'[A] state official in his . . . official capacity, when sued for injunctive relief, would be a person under § 1983 because 'official-capacity actions for prospective relief are not treated as actions against the State.'" *Id.* at 771, 413 S.E.2d at 283 (quoting *Will v. Michigan Dept. of State Police*, 491 U.S. 58, 71, 105 L. Ed. 2d 45, 58 (1989)) (citations omitted). In its complaint, plaintiff seeks monetary damages and declaratory relief, not injunctive relief. Therefore, plaintiff is not entitled to relief pursuant to 42 U.S.C.S. § 1983 or 42 U.S.C.S. § 1988.

Having decided the issue on Commerce Clause grounds, we need not address plaintiff's Due Process and Equal Protection arguments.

In sum, we hold that the portion of the State's intangibles tax scheme which increases the tax liability for owners of stock in corporations whose business and property is not completely in North Carolina violates the Commerce Clause of the United States Constitution. That language is excised from N.C. Gen. Stat. § 105-203. Plaintiff is entitled to no refund. The trial court's judgment for the defendant is reversed, and the cause is

remanded for entry of a judgment declaring the intangibles tax provision at issue in violation of the Commerce Clause. Plaintiff is entitled to no further relief.

Reversed and remanded.

Judges GREENE and WYNN concur.

APPENDIX C

N.C.Gen. Stat. § 105-203 (1992) provides in relevant part:

All shares of stock . . . owned by residents of this State . . . shall be subject to an annual tax, which is hereby levied, of twenty-five cents (25¢) on every one hundred dollars ($100.00) of the total fair market value of the stock on December 31 of each year less the proportion of the value that is equal to:

(1) [T]he proportion of the dividends upon the stock deductible by the taxpayer in computing its income tax liability under G.S. 105-130.7 without regard to the fifteen thousand dollar ($15,000) limitation under G.S. 105-130.7 . . . .

N.C. Gen. Stat. § 105-130.7 provides in relevant part:

(1) . . . the proportion of the entire net income of the corporation allocable to this State under the provision of G.S. 105-130.4, except as provided herein. . . . .

N.C. Gen. Stat. § 105-130.4 provides in relevant part:

§ 105-130.4 Allocation and apportionment of income for corporations.

. . . .

(b) A corporation having income from business activity which is taxable both

within and without this State shall allocate and apportion its net income as provided in this section. . . . .

(c)-(h) [contain rules for allocating specific types of corporate income such as interest and dividends to North Carolina if the corporation's commercial domicile is in the state, or the income has other connections with the state] . . .

(i) All business income of corporations . . . shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. . . . .

(j)(1) The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the corporation's real and tangible personal income owned or rented and used during the income year. . . .

(k)(1) The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the income year by the corporation as compensation, and the denominator of which is the total compensation paid everywhere during the income year. . . . .

(l)(1) The sales factor is a fraction, the numerator of which is the total sales of

the corporation in this State during the income year, and the denominator of which is the total sales of the corporation everywhere during the income year. . . . .

N.C.Gen. Stat. § 105-130.3 provides in relevant part:

A tax is imposed on the State net income of every C Corporation doing business in this State at seven and seventy-five one-hundredths percent (7.75%) of the corporation's State net income.

2

No. 94-1239

In The
Supreme Court of the United States
October Term, 1994

FULTON CORPORATION,
Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,
Respondent.

Petition For Writ Of Certiorari To The Supreme Court of North Carolina

---

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Does the taxable percentage deduction provided for in N.C. GEN. STAT. § 105-203, which levies the intangible personal property tax on shares of corporate stock owned by North Carolina residents, violate the Commerce Clause of the United States Constitution by reducing the taxable value of a stock by a percentage of the value equal to the percentage of the issuing corporation's income taxable in North Carolina?

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BRIEF IN OPPOSITION

Respondent Janice H. Faulkner, Secretary of Revenue of the State of North Carolina, respectfully requests that this Court deny the petition for a writ of certiorari seeking review of the opinion of the Supreme Court of North Carolina in this case. That opinion is reported *sub nom. Fulton Corp. v. Justus*, 338 N.C. 472, 450 S.E.2d 728 (1994).

STATEMENT OF THE CASE

A. The North Carolina Intangibles Tax

N.C. GEN. STAT. § 105-203 provides that "[a]ll shares of stock . . . owned by residents of this State . . . on December 31 of each year . . . shall be subject to an annual tax . . . of twenty-five cents ($.25) on every one hundred dollars ($100.00) of the total fair market value of the stock . . ."

The statute also provides for a deduction, commonly known as the taxable percentage deduction, which takes into account the North Carolina tax burden borne by the corporation whose stock is being taxed in the hands of the shareholder. It permits the shareholder, in computing his intangibles tax liability, to reduce the value of his stock by the percentage of value equal to the percentage of the issuing corporation's income subject to tax in North Carolina.[1]

The percentage of a corporation's total income taxable in North Carolina is determined under the provisions of N.C. GEN. STAT. § 105-130.4, the section of the Corporation Income Tax Act governing the allocation and apportionment

[1] N.C. GEN. STAT. § 105-203 refers to N.C. GEN. STAT. § 105-130.7, which authorizes a corresponding income tax deduction for dividend income reportable by the shareholder and which, in turn, refers to the state's corporate income tax laws. Copies of the relevant portions of N.C. GEN. STAT. §§ 105-203, 105-130.7, and 105-130.4, the corporate income apportionment statute, are included in the Appendix to the Petition at pages 36a-38a.

of corporate income. North Carolina uses a typical three-factor formula to apportion the business income of a multistate corporation based on the proportion of its total sales, property, and payroll attributable to the state.

The percentage of a corporation's income subject to tax in North Carolina is the corporation's "taxable percentage." If, for example, a multistate corporation has a taxable percentage of 38%, its resident shareholders are permitted under the taxable percentage deduction of N.C. GEN. STAT. § 105-203 to deduct 38% of the value of their stock in that corporation in determining their liability for intangibles tax. In such a case the stock would be described as 62% taxable for intangibles tax purposes. Similarly, a corporation engaged in business exclusively in North Carolina would itself be 100% taxable for income tax purposes, and its stock would be 0% taxable in the hands of its shareholders. Conversely, a corporation having no state income tax liability would be 0% taxable itself, but its shareholders would be taxable on 100% of the value of their stock.

The taxable percentage deduction is the only adjustment provided for in N.C. GEN. STAT. § 105-203. It applies uniformly to all stock held by residents of North Carolina without regard to whether the corporation issuing the stock is a foreign or domestic corporation and without regard to the state in which it maintains its commercial domicile.

B. Proceedings Below

As of December 31, 1990, Petitioner, a North Carolina corporation, owned stock in six other corporations.

Of these, five were 100% taxable for intangibles tax purposes, and the other was 54% taxable. Petitioner timely filed its 1990 intangibles tax return and paid under protest the tax shown due. When no refund was issued, Petitioner filed the present action to recover the tax paid. The complaint alleged, among other claims, that N.C. GEN. STAT. § 105-203, by virtue of the taxable percentage deduction, violated the Commerce Clause and the Equal Protection Clause of the United States Constitution.

The trial court entered summary judgment for the Respondent Secretary of Revenue, and Petitioner appealed. The North Carolina Court of Appeals did not decide the Equal Protection issue but ruled that the taxable percentage deduction violated the Commerce Clause. Petitioner was nevertheless denied relief because the court found the taxable percentage deduction to be severable from the balance of N.C. GEN. STAT. § 105-203 as a matter of state law. The court applied N.C. GEN. STAT. § 105-215, which directs that any judgment invalidating any clause, sentence, paragraph, or part of the Intangible Personal Property Tax Article be confined to that portion and not impair the remainder.

In a unanimous opinion authored by the Chief Justice, the Supreme Court of North Carolina reversed, holding that N.C. GEN. STAT. § 105-203 does not violate the Commerce Clause.[2] The court found the case to be controlled by *Darnell v. Indiana*, 226 U.S. 390, 33 S. Ct. 120, 57 L. Ed.

[2]Petitioner's Equal Protection claim was not before the court and was not decided.

267 (1912), this Court's only opinion involving a Commerce Clause challenge to a state intangible property tax on corporate stock. *Darnell* upheld Indiana's tax, finding that it achieved substantial equality in its treatment of the property of domestic corporations and the stock of foreign ones. The North Carolina court read *Darnell* as employing a compensatory tax analysis and concluded that N.C. GEN. STAT. § 105-203 created a compensatory tax scheme by considering the percentage of a corporation's income taxed in the state in determining the taxable value of its stock in the hands of its shareholders. The court rejected the argument that *Darnell* was distinguishable because North Carolina's offsetting corporate tax was an income tax rather than a property tax. It also rejected the suggestion that *Darnell* had been implicitly overruled by more recent Commerce Clause cases discussing the compensatory tax rationale. The court found such cases readily distinguishable from this one because they involved taxes falling directly upon the interstate commercial activity of multistate enterprises rather than a property tax having little or no effect on interstate commerce.

The North Carolina court made no finding as to whether N.C. GEN. STAT. § 105-203 was facially discriminatory. The opinion did recite that the intangibles tax was alleged to discriminate against the interstate ownership of corporate stock, but the court expressly found that the stock tax has no effect on a multistate corporation's trade and only a negligible effect on its ability to raise capital.

Following the entry of judgment by the Supreme Court of North Carolina, the Petition for a Writ of Certiorari was filed.

REASONS WHY THE WRIT SHOULD NOT BE GRANTED

I. THE PETITION SHOULD BE DENIED BECAUSE IT PRESENTS NO FEDERAL QUESTION WHICH HAS NOT BEEN, BUT SHOULD BE, DECIDED BY THIS COURT.

Petitioner asks this Court to grant the petition in order to pronounce that a state intangible personal property tax levied on resident shareholders--even one not in conflict with *Darnell* or with recent compensatory tax cases--must be analyzed under the internal consistency test announced in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 103 S. Ct. 2933, 77 L. Ed. 2d 545 (1983), and further developed in *Armco, Inc. v. Hardesty*, 467 U.S. 638, 104 S. Ct. 2620, 81 L. Ed. 2d 540 (1984), and later cases. Petitioner seeks a ruling that the test must be applied not simply to the stock tax paid by resident shareholders but to the aggregate tax liability of those shareholders and of the corporations in whose stock they have invested. Petitioner's proposed expansion of the test has no basis in the decisions of this Court, and it should not be adopted because it would not serve the interests protected by the Commerce Clause.

A. EVOLUTION OF THE INTERNAL CONSISTENCY TEST

The internal consistency test stems from this Court's decision in *Container Corp.*, which upheld a three-factor corporate income apportionment formula much like North Carolina's. The issue there was whether the statutory formula fairly attributed the income of a multistate corporation to the various taxing jurisdictions in which it operated. This Court stated that such a formula must have "what might be called internal consistency -- that is, the formula must be such that, if applied in every jurisdiction, it would result in no more than all the unitary business' income being taxed." 463 U.S. at 169, 103 S. Ct. 2933 at 2942.

The test was next applied in *Armco* to a claim that West Virginia's business and occupation (B&O) tax was unfairly apportioned and thereby discriminated against interstate commerce. Armco, a multistate manufacturer and seller of steel products, was not required to demonstrate that it suffered discrimination because of its obligation to pay specific taxes imposed by other states. Rather, the Court considered whether, if other states enacted West Virginia's B&O tax, multistate enterprises like Armco would be put at a competitive disadvantage. The tax was invalidated upon a finding that adoption of a like tax in other states would subject a multistate manufacturer/wholesaler to tax on both activities while its instate competitor, because of a multiple activities exemption in the West Virginia law, paid tax on only one.

Since *Armco*, the internal consistency test has been invoked to examine other kinds of state taxes. In *American Trucking Associations v. Scheiner*, 483 U.S. 2829, 107 S. Ct. 2920, 97 L. Ed. 2d 226 (1987), for example, it was used to strike down a Pennsylvania flat tax on motor carriers. The Court found that widespread adoption of such unapportioned taxes would subject interstate carriers to cumulative burdens and to relatively higher taxes than their instate competitors. In *Goldberg v. Sweet*, 488 U.S. 252, 109 S. Ct. 582, 102 L. Ed. 2d 607 (1989), it was applied to an Illinois tax on the privilege of originating or receiving interstate telephone calls. The Court upheld the tax based on its finding that any given call was potentially taxable by only two states and that, even if other states levied the same tax, the exclusion of calls not billed to an address within the state precluded taxation by more than one.

As these decisions illustrate, the internal consistency test has evolved somewhat since it was first articulated in *Container Corp.* It does not follow, however, that every Commerce Clause challenge to a state tax statute calls for review under the internal consistency test. Nor does it follow that the test should be applied in a given case by assuming any hypothetical tax structure that might be suggested by the facts of the case. More specifically, nothing in the development of the internal consistency test supports the adoption of an expanded test such as the one Petitioner urges upon the Court in this case. This Court never applied the test in a case involving a state property tax. It has never applied the test by hypothesizing the enactment in other states of a tax other than the very tax paid by the

complaining taxpayer. Nor has it ever measured the impact of a hypothetical tax in terms of its effect on two discrete categories of taxpayers.

B. Plaintiff's Proposed Version of the Internal Consistency Test Does Not Further the Purposes of the Commerce Clause.

The internal consistency test is not a doctrine unto itself. It is applied, if at all, only to assess whether interests protected by the Commerce Clause are unduly burdened by a state tax. The test should be revised or expanded only where necessary to protect such interests. This is not such a case.

The Commerce Clause is directed toward the preservation of free and open trade. *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 97 S. Ct. 599, 50 L. Ed. 2d 514 (1977). The inquiry in a Commerce Clause challenge to a state taxing statute is whether the practical operation of the tax provides a direct commercial advantage to local business, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 79 S. Ct. 357, 3 L. Ed. 2d 421 (1959), or subjects interstate businesses to multiple burdens not borne by their instate competitors, *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987).

Accordingly, the internal consistency test has been applied to taxes levied upon commercial activity in order to determine whether widespread adoption of the tax under

consideration would create a competitive imbalance between interstate and intrastate commerce.

The instant case does not fit this mold.

The intangibles tax on stock owned by North Carolina residents as of December 31 each year is not a tax on any type of commercial activity. It is not levied upon stock transactions or upon stocks as articles of commerce. The shareholder liable for the tax is a mere investor. He is not engaged in commerce, interstate or otherwise, as to the stock. The tax he pays under N.C. GEN. STAT. § 105-203 is a property tax. The subject of the tax is the relationship between the shareholder and the stock as of a fixed point in time. The relationship is an indivisible one occurring in North Carolina and nowhere else.[3] A tax on that relationship poses no risk of multiple taxation and upsets no competitive equilibrium.

The internal consistency test simply makes no sense where, as here, the tax in question is not levied upon an activity in interstate commerce. Petitioner concedes as much by raising no argument that the adoption of a statute like N.C. GEN. STAT. § 105-203 by other states would cause stock held by any resident shareholder to be taxed at more than 100% of its value or by more than one state. As Petitioner must recognize, the tax on shareholders, even if

[3]Petitioner concedes that "the instant case does not raise the difficult issues surrounding taxation of the same property by two states, each of which has a reasonable ground for taxing it." Petition p. 12.

replicated in all fifty states, does not unduly burden interstate commerce because stock ownership is not an event in interstate commerce. Petitioner's solution is to expand the test until it includes some form of interstate commerce, even if that commerce is conducted by a party other than the taxpayer liable for the tax under review.

Petitioner asks this Court to hypothesize not only that other states adopt a statute identical to N.C. GEN. STAT. § 105-203 but that they also adopt North Carolina's corporate income tax laws. Further, Petitioner's test would judge this hypothetical dual tax scheme by measuring its effect not only on shareholders such as itself but on the combined liability of shareholders for intangibles tax and of corporations for corporate income tax.

Not only does Petitioner's version of the internal consistency test represent a radical departure from this Court's prior applications of the test, but it makes this quantum leap without in any way advancing interests protected by the Commerce Clause.

On these facts, the only business activity requiring Commerce Clause protection is that conducted by the corporations. The only tax touching on that activity is the corporate income tax. The corporate income tax readily passes the internal consistency test because it fairly apportions income according to a three-factor apportionment formula of the kind approved in *Container Corp*. Aggregating the corporation and its shareholders adds nothing to the inquiry. It has no basis in economic reality. The commerce

carried on by the corporation is not a joint undertaking by the corporation and its shareholders. The shareholders undoubtedly hope that the corporation will prosper because of their concern for stock values, but it is the corporation alone that conducts the corporate business. Aggregating corporations and shareholders does not transform shareholders into interstate actors, and it does not transform stock ownership into an interstate event.

This Court should not grant the Petition in this case to consider Petitioner's suggested revision to the internal consistency test. Petitioner's proposal expands the test in ways not supported by this Court's fundamental Commerce Clause analysis or its prior applications of the test.

C. THE FEDERAL QUESTION RAISED BY THIS CASE IS NOT ONE OF GENERAL INTEREST.

Petitioner directs the Court's attention to two recent state appellate court decisions involving Commerce Clause attacks upon state intangibles taxes on shares of stock. The Indiana and Kentucky statutes at issue both took into account the property tax paid in the state by the corporation issuing the stock, and both taxes were upheld based on reasoning similar to that of the Supreme Court of North Carolina in this case.

Petitioner argues that these decisions signal a departure from this Court's internal consistency opinions and that, unless this Court intervenes, other state courts are likely to follow suit.

The Indiana and Kentucky cases were correctly decided, but, in any event, the issue to which they speak is not one on which a large number of states require guidance from this Court. According to a 1993 publication of the U.S. Advisory Commission on Intergovernmental Relations, only twelve of the states taxing any kind of intangible property include within their tax base shares of corporate stock or other equities. Of the twelve, only four, including North Carolina and Kentucky, have statutes making any allowance for other state taxes paid by the corporation issuing the stock.[4] U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM: BUDGET PROCESSES AND TAX SYSTEMS, Table 45, p. 161 (1993).[5]

II. THE PETITION SHOULD BE DENIED BECAUSE THE DECISION OF THE SUPREME COURT OF NORTH CAROLINA IS NOT IN CONFLICT WITH A DECISION OF THE U.S. COURT OF APPEALS.

Petitioner contends that the issues raised by its proposed extension of the internal consistency test are "essentially the same" as the questions decided by the Second Circuit in *Barringer v. Griffes*, 1 F.3d 1331 (2nd Cir. 1993), *cert. denied*, __ U.S. __, 114 S. Ct. 879 (1994), and that the

---

[4]The Indiana Intangibles Tax Act has been repealed. Pub. L. No. 80-1989, §§ 18, 19, 1989 Ind. Acts 912, 919.

[5]A copy of the table is reproduced in the attached Appendix at pages 1a-2a.

decision below conflicts "in principle" with *Barringer*. Petition p. 14.

The issue in *Barringer* was whether a Vermont vehicle use tax collected at the time of registration discriminated against persons relocating to Vermont by allowing a credit for sales tax paid to Vermont but not for sales tax paid to other states. The court invalidated the tax based on its finding that a taxpayer bringing a vehicle into Vermont from another state would pay more tax over the life of the vehicle than would a taxpayer purchasing and registering an identical vehicle in Vermont.

The Second Circuit applied the internal consistency test in reaching its decision, but its test assumed only that other states enacted Vermont's use tax scheme. *Barringer* did not depart from any previous formulation of the test by this Court. It most certainly did not extend the test, as Petitioner urges, to a state property tax. Nor did it posit the adoption by other states of two Vermont taxes or consider the aggregate liability under such a hypothetical tax structure of two different categories of taxpayers.

Barringer and the present case are distinguishable both on the facts and the law. There is no conflict between them requiring review by this Court.

III. THE PETITION SHOULD BE DENIED BECAUSE THE SUPREME COURT OF NORTH CAROLINA CORRECTLY APPLIED THE RELEVANT DECISIONS OF THIS COURT.

A. THE SUPREME COURT OF NORTH CAROLINA CORRECTLY FOLLOWED *DARNELL V. INDIANA*.

Darnell v. Indiana is this Court's only pronouncement on the application of the Commerce Clause to a state property tax on corporate stock owned by resident shareholders. It has never been overruled or even questioned by this Court, and the principles for which it was relied upon by the Supreme Court of North Carolina are as valid today as they were when Justice Holmes issued the opinion.

Darnell dealt with an Indiana intangibles tax that applied to the stock of domestic corporations to the extent the property of the corporation had not been taxed in the state and to the stock of foreign corporations without allowance for any Indiana property tax paid by the corporation. Since Mr. Darnell, the taxpayer in the case, owned stock in a Tennessee corporation that had paid no Indiana property tax, the Court reviewed the intangibles tax only in relation to that stock and did not consider whether the failure to allow for Indiana property tax paid by foreign corporations violated the Commerce Clause:

> The only difference of treatment disclosed by the record that concerns the [taxpayer] is that the state taxes the property of domestic corpo-

> rations and the stock of foreign ones in similar cases. That this is consistent with substantial equality not-withstanding the technical differences was decided in *Kidd v. Alabama*, 188 U.S. 730, 23 S. Ct. 401, 47 L. Ed. 669 (1903).[6]

Darnell, 226 U.S. at 398, 33 S. Ct. at 121, 57 L. Ed. at 273.

The North Carolina court found in North Carolina's intangibles tax the same "substantial equality" this Court found in *Darnell*. It concluded that N.C. GEN. STAT. § 105-203 creates "the very kind of 'compensating' tax scheme the Supreme Court upheld in *Darnell*." *Fulton Corp. v. Justus*, 338 N.C. at 478, 450 S.E.2d at 732.[7]

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[6]*Kidd* had rejected an Equal Protection challenge to an Alabama tax similar to Indiana's. It recognized that, in the case of "corporations formed and having their property and business elsewhere, the state must tax the stock held within the state if it is to tax anything." 188 U.S. at 732, 47 L. Ed. 669 at 672. Justice Holmes also explained in *Kidd* that a state levying a stock tax on shareholders may "look behind the present net values of different stock" and "may take into account [whether] the property and franchise of the corporation are untaxed" in the state. *Id.*

[7]The facts of this case did not require the North Carolina court to decide the question left unresolved by *Darnell*: whether a failure to allow for state tax paid by the issuing corporation causes an intangibles tax levy to violate the Commerce Clause. North Carolina's statute risks no such infirmity. It allows an offset for income tax paid at the corporate level without regard to whether the corporation is foreign or domestic.

Petitioner is simply mistaken in arguing that the North Carolina court misapplied *Darnell* by recognizing the state's corporate income tax rather than a corporate property tax as a proxy for the intangibles tax on stock values. As the opinion below makes clear, corporate income produced by the entire enterprise and apportioned to North Carolina is far more closely related to corporate stock values than is the value of instate corporate property alone.

B. THE DECISION OF THE SUPREME COURT OF NORTH CAROLINA IS NOT IN CONFLICT WITH THIS COURT'S COMPENSATORY TAX DECISIONS.

Petitioner argues that the decision upholding North Carolina's intangibles tax on stock cannot be justified in light of this Court's recent decisions applying the compensatory tax analysis to a state tax found to discriminate against interstate commerce on its face.[8]

In support of this proposition Petitioner cites the Court to three compensatory tax decisions. The first is *Armco*, discussed above in connection with the internal consistency test. In considering whether the West Virginia tax on instate manufacturing compensated for the wholesaling tax on out-

---

[8]The Supreme Court of North Carolina made no finding of facial discrimination but did, in its discussion of the continuing validity of *Darnell*, distinguish this case from the compensatory tax cases Petitioner relied upon before that court.

of-state manufacturer/wholesalers, the Court in *Armco* observed that manufacturing and wholesaling are not "substantially equivalent events." The Court went on to examine certain features of the manufacturing tax and, on that basis, to conclude that the manufacturing tax was indeed a tax on manufacturing alone and that it was not intended as a proxy for the wholesaling tax on out-of-state enterprises. Petitioner ignores this more extensive analysis of the tax structure and instead seizes upon the phrase "substantially equivalent events" as if it capsulized the Court's entire view of the issue.

In this vein, Petitioner also cites the Court to *Oregon Waste Systems, Inc. v. Department*, __ U.S. __, 114 S. Ct. 1345, 128 L. Ed. 2d 13 (1994), in which it had been argued that a waste disposal surcharge levied upon out-of-state businesses bringing nonhazardous waste into Oregon from out of state was offset by the general tax burden borne by their Oregon counterparts. In this context the Court found that taxes on earning income and taxes on landfills were not directed at substantially equivalent events.

Finally, Petitioner cites to *Associated Industries of Missouri v. Lohman*, __ U.S. __, 114 S. Ct. 1815, 128 L. Ed. 2d 639 (1994), to demonstrate that the existence of a compensatory tax scheme must be proved with mathematical precision. *Associated Industries* struck down Missouri's use tax in those local jurisdictions where the use tax on out-of-state purchases exceeded the sales tax.

Based upon these examples of the Court's compensatory tax analysis, Petitioner states that the intangibles tax and the corporate income tax are levied at different rates and that owning stock and earning income are not substantially equivalent events, and it concludes without further analysis that the two taxes, therefore, cannot be compensatory. Petitioner's reasoning disregards the inherent equivalency this Court found in *Darnell* by virtue of the relationship between a corporation and its shareholders. It also ignores the 101 taxable percentages provided for in N.C. GEN. STAT. § 105-203 and the precision with which they balance the intangibles tax borne by shareholders and the income tax borne by corporations.

Petitioner's argument also blurs a fundamental distinction between the cited cases and the present one. As the Supreme Court of North Carolina noted, this Court's recent compensatory tax cases have uniformly dealt with taxes levied upon the interstate movement of goods, the quintessential Commerce Clause concern. This one, by contrast, involves a property tax paid only by state residents and having little if any potential impact on interstate commerce. One may view this distinction, as the North Carolina court did, as grounds for distinguishing the cases. Alternatively, the cases can be harmonized as instances of case-by-case analysis geared to the practical implications for interstate commerce. Whichever understanding is correct, there is no conflict between the decision below and those of this Court, and no further review by the Court is required.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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February 16, 1995 *Counsel for Respondent

APPENDIX

CONTENTS OF APPENDIX

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PAGE 161 FROM U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM: BUDGET PROCESSES AND TAX SYSTEMS (1993)

Table 45

Details of Intangibles Tax Base by State

State	Base Items (see key at end of table)	Number
Alabama	A,B	2
Florida	A,B,E,F,H,O	5
Georgia	A,[1]B,C,D,E,I,J,K,L,M,O	11
Iowa	O	1
Kansas	A,B,C,D,E,[2]F,H,I,O	9
Kentucky	A,[1]B,C,D,E,F,G,H,I,J,K,L, M,O	14
Louisiana	A,[1]B,[1]E,[1]O	4
Michigan	A,B,C,D,E,F,H,I	8
Mississippi	O	1
Missouri	O	1
New Hampshire	A,B,C,E,G,I,O	7
North Carolina	A,[1]B,E,F,H	5
North Dakota	O	1
Ohio	O	1
Pennsylvania	A,[3]B,E,I,O	5

[1] Equities of firms paying selected other state taxes may be exempt from this tax.

[2] Mortgages and notes secured by in-state real property are exempt.

[3] Types of firms whose equities are subject to tax is very limited.

Rhode Island	C	1
Tennessee	A,[3]B,[4]C,[4]E,[4]H,I,[4]O	7
Texas	O	1
Washington	N	1
West Virginia	A,B,F,G,I,J,K,M,O	9
Wyoming	O	1

Key to Intangible Base Categories [number of states]

A-Equities [12]
B-Bonds [12]
C-Deposits [7]
D-Cash [4]
E-Mortgages [10]
F-Accounts receivable [6]
G-Cash value of insurance policies [3]
H-Interest in trusts [6]
I-Other financial instruments [8]
J-Patents [3]
K-Copyrights and trademarks [3]
L-Licenses [2]
M-Franchises [3]
N-Computer software [1]
O-Other [17]

Source: John H. Bowman, George E. Hoffer, and Michael D. Pratt, "Current Patterns and Trends in State and Local Intangibles Taxation," *National Tax Journal*, December 1990.

[4] Income subject to intangible personal property tax if duration of instrument contract is six months or greater.

(3)

No. 94-1239

IN THE SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,

Respondent.

On Writ of Certiorari to the Supreme Court of North Carolina

JOINT APPENDIX

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Petition for Writ of Certiorari was filed on 1/17/95
Petition for Writ of Certiorari was granted on 4/17/95

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FULTON CORPORATION V. JANICE H. FAULKNER, SECRETARY OF REVENUE

No. 94-1239

Relevant Docket Entries

Date	Proceedings
05/1/91	Complaint filed
05/31/91	Answer filed
09/6/91	Plaintiff's Motion for Summary Judgment filed
09/30/91	The following exhibits were filed in support of Plaintiff's Motion for Summary Judgment:
	Deposition of Frank S. Goodrum, Jr.
	Affidavit of J.D. Freeman to which is attached the return of tax for which refund is sought herein
	State of North Carolina Intangible Personal Property Tax Rules and Regulations for Taxable Year 1989
	Intangibles Tax Section Stock and Bond Values as of December 31, 1990
	Taxable Percentages for N.C. Income and Intangibles Tax Purposes as of December 31, 1990

	Affidavit of Robert Gibbs Smith
10/4/91	Defendant's Motion for Summary Judgment filed
10/25/91	The following exhibits were filed in support of Defendant's Motion for Summary Judgment:
	Affidavit of S. Nicole Underwood
	Affidavit of Anthony H. Doster
	Affidavit of Danny L. Massey
11/15/91	Order Allowing Defendant's Motion for Summary Judgment and Denying Plaintiff's Motion for Summary Judgment filed
01/8/92	Record on Appeal in North Carolina Court of Appeals (including separate deposition of Frank S. Goodrum, Jr., Intangibles Tax Section Stock and Bond Values as of December 31, 1990, Taxable Percentages for N.C. Income and Intangibles Tax Purposes as of December 31, 1990) filed
6/11/92	Opinion of North Carolina Court of Appeals filed

12/9/94	Opinion of the Supreme Court of North Carolina filed
1/13/95	Petition for Writ of Certiorari to Supreme Court of the United States filed
2/16/95	Respondent's Brief in Opposition to Petition for Writ of Certiorari filed
4/17/95	Order of United States Supreme Court Granting Certiorari filed

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WAKE COUNTY SUPERIOR COURT
(Title Omitted in Printing)
COMPLAINT

COMES NOW the Plaintiff which alleges and says:

Parties

1. Plaintiff is a corporation chartered under the laws of the State of North Carolina, having its principal place of business in Salisbury, N.C.

2. Defendant is the Secretary of Revenue of the State of North Carolina. She is being sued in her official capacity only.

Jurisdiction

3. This action is brought pursuant to N.C.G.S. § 105-267 for refund of intangibles taxes paid by Plaintiff to defendant for tax year 1990 and pursuant to the general jurisdiction of this court to adjudicate claims under 42 U.S.C. § 1983. All conditions precedent to the filing of this action have been met.

Facts

4. Plaintiff has paid intangibles tax levied under N.C.G.S. § 105-198 et seq. to defendant for the tax year 1990 in the amount of $10,884.00. On January 30, 1991, Plaintiff demanded refund of this tax in the manner required by N.C.G.S. § 105-267 and 90 days have expired after that date without any refund being forthcoming.

5. Defendant imposed this tax under N.C.G.S. § 105-203 upon corporate stock (including mutual fund shares) owned by Plaintiff in other corporations that either (1) have no income allocable to this State for North Carolina corporate income tax purposes and thus have no income subject to the North Carolina income tax or (2) have only a minority portion of their income allocable to this State and thereby subject to the North Carolina income tax.

6. The said allocation outside of North Carolina of all or the majority part of the incomes of these other corporations is required by various provisions of Chapter 105 because these corporations' commercial domiciles are located outside of this State, or because their property holdings or business situs or activities are located outside of this State.

7. The out-of-state locations of the commercial domiciles, property and activities of these other corporations affect the Plaintiff's intangibles tax liability on shares of their stock because the percentage of each such corporation's income that is not allocable to this State (100% in most cases) is required by Chapter 105 to be multiplied times the value of its stock to yield the amount subject to intangibles tax in Plaintiff's return.

8. Therefore, the Plaintiff's intangibles tax liability on the stock of these other corporations increases due to their out-of-state business and property locations. Conversely, the more local their business and property, the less would their shares be subject to intangibles tax in the hands of North Carolina taxpayers. Furthermore, owners of "purely local" North Carolina corporations pay no intangibles tax on their shares.

First Cause of Action

Commerce Clause

9. The taxing scheme described in paragraphs 5-8 violates the Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3, and so Plaintiff is entitled to refund of the $10,884.00 taxes it paid, with interest from date of payment.

Second Cause of Action

Uniformity/Equal Protection

10. The taxing scheme described in paragraphs 5-8 results in taxation of a single class of property (corporate stock) in a manner that is not uniform in violation of Clause (2), Section

2, Article V of the North Carolina Constitution, and denies to Plaintiff due process of law and the equal protection of the laws in violation of Section 19 of Article 1 of the North Carolina Constitution and the Fourteenth Amendment to the United States Constitution, and so Plaintiff is entitled to refund of $10,884.00 taxes it paid, with interest from date of payment.

Third Cause of Action

42 U.S.C. § 1983

11. The taxing scheme described in paragraphs 5-8 and enforced by Defendant under color of State law violates Plaintiff's civil rights under the Commerce Clause of the United States Constitution and under the due process clause and the equal protection clause of the Fourteenth Amendment to the United States Constitution and Plaintiff is entitled to a declaration that N.C.G.S. § 105-203 is unconstitutional, to damages in the amount of $10,884.00 with interest from payment of said amount to Defendant, plus attorneys fees, as provided by 42 U.S.C. §§ 1983 and 1988 and the recent decision of the United States Supreme Court in Dennis v. Higgins, ___ U.S. ___ (1991).

Prayer for Relief

WHEREFORE, Plaintiff demands:

a. A judgment declaring that N.C.G.S. § 105-203 violates the United States Constitution and the North Carolina Constitution and therefore is null and void insofar as it imposes a tax on any corporate stock (including mutual fund shares);

b. A judgment ordering defendant to refund to Plaintiff $10,884.00 with interest from date of payment of said amount by Plaintiff to Defendant, plus Plaintiff's attorneys fees, expenses and costs;

c. Such other and further relief as to the court shall seem appropriate.

This is the 1st day of May, 1991.

/s/ Jasper L. Cummings, Jr.
Jasper L. Cummings, Jr.

WAKE COUNTY SUPERIOR COURT
(Title Omitted in Printing)
ANSWER

NOW COMES the Attorney General on behalf of the Defendant and, answering plaintiff's complaint, alleges and says:

FIRST DEFENSE

1. Paragraph 1 is admitted;

2. Paragraph 2 is admitted;

3. It is admitted that this is an action brought pursuant to G.S. § 105-267 for the refund of intangible personal

property tax paid by plaintiff to defendant for taxable year 1990 and that all conditions precedent to the right of plaintiff to bring suit for refund under that section have been met. The remaining allegations of Paragraph 3 are denied, and it is expressly denied that jurisdiction lies under 42 U.S.C. § 1983;

4. Paragraph 4 is admitted;

5. It is admitted that G.S. § 105-203 imposes an intangible personal property tax on shares of stock owned by North Carolina residents. The remaining allegations of Paragraph 5 are denied for the reason that the provisions of G.S. § 105-203 speak for themselves. Further, it is expressly denied that defendant imposed the intangibles tax;

6-8. The extent to which plaintiff is liable for intangible personal property tax with respect to shares of stock is governed by G.S. § 105-203, the provisions of which statute speak for themselves. The allegations of Paragraphs 6-8 are, therefore, denied; and

9-11. Paragraphs 9-11 are denied.

SECOND DEFENSE

In the event this Court determines that G.S. § 105-203 is unconstitutional, that determination should operate prospectively only.

WHEREFORE, having fully answered plaintiff's complaint, defendant respectfully prays the Court:

1. That plaintiff have and recover nothing of the defendant;

2. That plaintiff's action be dismissed;

3. That no costs or fees be taxed against defendant; and

4. For such other and further relief as to the Court may seem just and proper.

This the 31st day of May, 1991.

LACY H. THORNBURG
Attorney General

/s/ Marilyn R. Mudge
Marilyn R. Mudge

Assistant Attorney General

(Certificate of Service Omitted in Printing)

WAKE COUNTY SUPERIOR COURT
AFFIDAVIT OF J.D. FREEMAN

I, J.D. Freeman, hereby swear that the following statements are true of my own personal knowledge.

I signed the 1990 Intangible Personal Property Tax Return for Fulton Corporation as its Assistant Secretary. A true copy of that return is attached to this affidavit as Exhibit A.

This the 9th day of August, 1991.

/s/ J.D. Freeman (SEAL)
J.D. Freeman

(Jurat Omitted in Printing)

EXHIBIT A

*** [Only the schedule of stock intangibles is included. The entire return appears at pp. 16-17 of the Record on Appeal in the North Carolina Court of Appeals.]

PART IV - SHARES OF STOCK; UNITS OF INVESTMENT FUNDS, ETC. (G.S. 105-203)								
List all shares of stock owned as of December 31. Also, list units of ownership of mutual funds, investment trusts and investment funds (including money market funds) regardless of the taxable status or class of the property held by the fund or trust or the fact that drafts or checks may be drawn against such funds. If indebtedness is claimed on Line 20, indicate in the proper spaces below an "x" showing the shares and units purchased and pledged. See INSTRUCTIONS for further information.								
NAME OF ISSUER		INDEBT-EDNESS	CLASS COM.PFD. ETC.	NO. OF SHS/UNITS	QUOTATION DEC.31, 1990	TOTAL FAIR MARKET VALUE AT DEC.31,1990	% TAXABLE	TOTAL TAXABLE VALUE
(a)	Capital Cities/ABC		C	600	$ 459.125	$ 275,475	100	$ 275,475
(b)	Federal Home Loan Mtg		C	4,000	48.750	195,000	100	195,000
(c)	Food Lion		A	439,248	13.125	5,765,130	54	3,113,170
(d)	Lee Enterprises		A	22,500	24.750	556,875	100	556,875
(e)	Washington Post		B	900	198.000	178,200	100	178,200
(f)	Vanguard ARP Fund		C	1,984	17.600	34,918	100	34,918
TOTAL FAIR MARKET VALUE						$ 7,005,598	XXXXXX	$
TOTAL TAXABLE VALUE AS OF DECEMBER 31, 1990								4,353,638

WAKE COUNTY SUPERIOR COURT

STATE OF NORTH CAROLINA INTANGIBLES PERSONAL PROPERTY TAX RULES AND REGULATIONS FOR TAXABLE YEAR 1989 [Excerpt p. 21; this excerpt appears at pp. 13-14, Record on Appeal]

The taxable value of shares of stock is determined by multiplying the fair market value of the stock by the "taxable percentage" applicable to such stock. Since taxable percentages of stocks may vary from year to year, the intangibles tax section publishes a percentage list each year. This list is available, upon written request, for use by accountants, tax practitioners, attorneys and other parties preparing intangibles tax returns. Moreover, taxable percentages for certain stocks may be obtained from local revenue offices or by writing directly to the intangibles tax section. Corporations which furnish stockholders the taxable percentages of their stock should verify the taxable percentage with the intangibles tax section before notifying stockholders. Taxable percentages are computed by the Corporate Income and Franchise Tax Division of the North Carolina Department of Revenue, using the applicable allocation formula provided by law. Generally, the following rules apply:

(1) Stocks of corporations which operate "entirely within" North Carolina are not taxable.

(2) Stocks of corporations which operate "entirely outside" North Carolina are taxable at 100 percent.

(3) Stocks of corporations which derive income from both in and out of North Carolina are taxable at a percentage equal to the percent of such corporation's entire net income allocated outside North Carolina.

(4) Parent and subsidiary corporations are considered as separate and distinct legal entities, and the fact that a subsidiary corporation pays to the State of North Carolina a franchise tax, a property tax and an income tax does not affect the taxability of shares of stock of the parent corporation.

(5) In the case of mutual funds, investment trusts and investment funds which are located outside North Carolina and which are not required to file income tax returns with this State, the shares of units of such funds or trusts are 100% taxable. If such funds or trusts operate in this State and are required to file income tax returns with North Carolina, then the taxable percentages of the shares or units will be computed in accordance with the law.

WAKE COUNTY SUPERIOR COURT
AFFIDAVIT

I, Robert Gibbs Smith, do hereby swear and affirm that the following statements are true of my own personal knowledge.

I am a resident of North Carolina and I have invested in various corporate stocks. In making my investments I have been aware of the fact that when the "taxable percentage" of the corporate stock is low it will be less subject to the North Carolina intangibles tax. Therefore, I have in fact in the past selected stocks to buy partly because they had a low "taxable percentage" for North Carolina intangibles tax purposes.

This the 29th day of August, 1991.

/s/ Robert Gibbs Smith (SEAL)
Robert Gibbs Smith

(Jurat Omitted in Printing)

WAKE COUNTY SUPERIOR COURT
(Title Omitted in Printing)
AFFIDAVIT OF S. NICOLE UNDERWOOD
IN SUPPORT OF DEFENDANT'S MOTION
FOR SUMMARY JUDGMENT

S. NICOLE UNDERWOOD, being first duly sworn, deposes and says:

1. I am over eighteen years of age and make this affidavit of my own personal knowledge;

2. I am presently the Director of the Tax Research Division of the North Carolina Department of Revenue, a position I have held since September 1, 1986. I have been employed by the Department of Revenue since October 1, 1971. Prior to that date I was employed for 8 years by the Department of Tax Research, which was merged into the Department of Revenue on October 1, 1971;

3. The Tax Research Division compiles information concerning North Carolina's state and local tax structure and furnishes it to the Governor, the General Assembly, the Advisory Budget Commission, other state agencies, industrial prospects, and the general public. As director of the Tax Research Division, I am familiar with all of the tax schedules administered by the Department of Revenue pursuant to the North Carolina Revenue Laws, including the intangible personal property tax. I am also familiar with the requests for tax information received by the Division and with the Division's responses;

4. The Tax Research Division responds to requests for information on behalf of corporations considering locating a facility within North Carolina or otherwise expanding their business into the state. These inquiries are received from the Industrial Development Division of the Department of Economic and Community Development, local economic development agencies, private site selection consulting firms, and the corporations themselves;

5. Inquiries by or on behalf of these industrial prospects typically relate to the state corporate income and franchise taxes, the local ad valorem tax, and other taxes for which the corporation will be liable by virtue of its property or activity within North Carolina;

6. To the extent that such inquiries concern the intangible personal property tax, they most often involve the corporation's liability for the tax imposed by G.S. § 105-201 on its accounts receivable;

7. To my knowledge, the Tax Research Division has received no requests from corporate industrial prospects for information concerning the liability of their North Carolina resident shareholders for the tax imposed by G.S. § 105-203 upon shares of stock.

Further affiant says not.

/s/ S. Nicole Underwood
S. Nicole Underwood

(Jurat Omitted in Printing)

WAKE COUNTY SUPERIOR COURT
(Title Omitted in Printing)
AFFIDAVIT OF ANTHONY H. DOSTER IN SUPPORT OF DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

ANTHONY H. DOSTER, being first duly sworn, deposes and says:

1. I am over eighteen years of age and make this affidavit of my own personal knowledge;

2. I am presently the Assistant Director of the Business/Industry Development Division of the North Carolina Department of Economic and Community Development. I have served in that capacity since April 1, 1989. From December, 1986, until assuming my current position, I served as Assistant Director of the Tax Research Division of the North Carolina Department of Revenue. My prior experience in the areas of tax and financial management and data processing was both in the private sector and with the United States House of Representatives;

3. In my capacity as Assistant Director of the Business/Industry Development Division, I am responsible for research, publications, advertising, marketing, and tax consultation in support of business recruitment for the State of North Carolina. I consult with business and industrial prospects concerning the North Carolina tax consequences of establishing a facility within the State. I am familiar with the application of the North Carolina tax laws to business

enterprises, including multistate corporations and their shareholders. I am also familiar with the matters which are of concern to an out-of-state or multistate corporation considering locating a facility within the state;

4. Corporations interested in developing or expanding their interstate activity by locating a facility in North Carolina are typically concerned about the following areas: the availability of a labor pool with appropriate skills, prevailing wages, the availability of buildings and sites, utilities and utility rates, the quality of higher education, the cultural environment, transportation, the availability of financing, and the state tax structure;

5. Inquiries by multistate corporations concerning the state tax structure relate to the North Carolina tax consequences of the corporations' anticipated activity within the state. These questions most often concern the corporations' liability for corporate income and franchise taxes, sales and use taxes, local property taxes, and the intangibles tax on their accounts receivable;

6. Inquiries by multistate corporations concerning the availability of financing within the state relate to banking practices and state and local governmental incentives. To my knowledge, not one of the more than 150 corporate prospects with whom I have consulted during my tenure as Assistant Director of the Business/Industry Development Division has inquired concerning the effect of the tax imposed by G.S. § 105-203 on the corporation's ability to raise capital.

Further affiant says not.

/s/ Anthony H. Doster
Anthony H. Doster

(Jurat Omitted in Printing)

WAKE COUNTY SUPERIOR COURT
(Title Omitted in Printing)
AFFIDAVIT OF DANNY L. MASSEY
IN SUPPORT OF DEFENDANT'S MOTION
FOR SUMMARY JUDGMENT

DANNY L. MASSEY, being first duly sworn, deposes and says:

1. I am over eighteen years of age and make this affidavit of my own personal knowledge;

2. I have been employed in the Intangibles Tax Division (now Section) of the North Carolina Department of Revenue for 25 years. I was first employed as an auditor and later served as Audit Supervisor and Assistant Director of the Division. On January 1, 1987, I was appointed Chief of the Intangibles Tax Section, and I have held that position since that date;

3. In my capacity as Chief of the Intangibles tax Section, I am familiar with the Intangibles Personal Property Tax Article of the North Carolina Revenue Laws, G.S. §§ 105-198 et seq. I have custody of the records of the Intangibles Tax Section and am familiar with those pertaining to Fulton Corporation, the plaintiff in this action;

4. I am familiar with the provisions of G.S. § 105-203, which imposes the tax on shares of stock owned by North Carolina residents and which allows a deduction from the value of such stock related to the "taxable percentage" of the issuing corporation. This deduction has been a part of statute now codified as G.S. § 105-203 since 1939;

5. To my knowledge, excepting the correspondence preceding the filing of this suit, the Intangibles Tax Section has since 1939 received no letter or other communication concerning the constitutionality of the "taxable percentage" deduction or its effect on the ability of interstate corporations to attract capital;

6. As evidenced by its Articles of Incorporation, a certified copy of which is attached as Exhibit A, plaintiff was organized as L and S Furniture Company in 1940. In 1964 the Articles were amended to change the corporate name to Fulton Corporation and to authorize the corporation to "acquire and hold shares, stocks, debentures, debenture stocks, bonds, obligations, and securities issued or granted by any Company constituted or carrying on business in the United States, or in any colony, or dependency, or possession thereof, or in any foreign country . . ."

7. As reflected on its 1990 intangible personal property tax return, a copy of which is attached as Exhibit B, Fulton Corporation's stock portfolio as of December 31, 1990, included shares in six corporations, five of which were reported as 100% taxable under G.S. § 105-203. The remaining corporation was reported as 54% taxable. The total value of Fulton's stock portfolio was $7,005,598.00, of which $4,353,638 was reported as taxable under G.S. § 105-203.

Further affiant says not.

/s/ Danny L. Massey
Danny L. Massey

(Jurat Omitted in Printing)

[Exhibit A]

To all whom these presents shall come, Greeting:

I, Rufus L. Edmisten, Secretary of State of the State of North Carolina, do hereby certify the following and hereto attached (8 sheets) to be a true copy of

ARTICLES OF INCORPORATION
OF
FULTON CORPORATION

the original of which is now on file and a matter of record in this office.

In Witness Whereof, I have hereunto set my hand and affixed my official seal.

Done in Office, at Raleigh, this 24th day of October in the year of our Lord 1991.

[State Seal] /s/ Rufus L. Edmisten
Secretary of State

THIS IS TO CERTIFY that we, the undersigned, do hereby associate ourselves into a corporation under and by virtue of the laws of the State of North Carolina, and do hereby severally agree to take the number of shares of capital stock in said corporation set opposite our respective names, and to that end do hereby agree:

FIRST: The name of this corporation is L. AND S. FURNITURE COMPANY.

SECOND: The location of the principal office of the corporation in this State shall be at Salisbury, Rowan County, North Carolina, but the corporation may have one or more places of business out of the State as well as in said State.

THIRD: The objects and purposes for which this corporation is formed are as follows:

(a) To engage in the retail furniture business - buying, selling and handling furniture, house furnishings and such other articles as are accustomarily handled and sold in connection with such a retail business.

(b) To do a general furniture and house goods business; to manufacture, repair, alter, purchase, sell, exchange, import, lease, rent, and deal in, as principal and on its own behalf, as well as agent or factor for others, all kinds of modern or antique furniture, musical instruments, rugs, carpets and other floor coverings, curtains, draperies, tapestries and pictures of every kind, statuary, bronzes, works of art, bric-a-brac, glass, stoves, ranges and all kinds of articles used and intended to be used, or capable of being used in furnishing or in beautifying or equipping and rendering liveable, any private home, office or public building.

(c) To sell or otherwise dispose of said merchandise either at wholesale or at retail, for cash, on open account, or on the installment payment plan, and to take and receive, own, hold, sell, exchange, hypothecate, or otherwise deal in chattel mortgages, conditional ales contracts, open notes and open accounts, leases, and other evidences of indebtedness of every kind or description.

(d) To own undivided interests in one or more partnerships and to be either a general or a limited partner therein, subject to all liabilities and having and using all powers and privileges prescribed by the laws of the State of North Carolina with respect to partnerships, and no officer, director nor stockholder shall be subject to any individual and personal liability because of, arising out of, or resulting from the ownership by this corporation of such partnership interest.

(e) And in order to properly prosecute the objects and purposes above set forth the corporation shall have full power and authority to purchase, lease, or otherwise acquire, hold, manage, operate, mortgage, pledge, convey, and

otherwise dispose of all kinds of property, both real and personal; to purchase the business, good will and all other property of any individual, firm or corporation as a going concern, and to assume all its debts, contracts and obligations; to construct, equip, maintain and operate buildings, factories, repair shops, storage warehouses and other establishments; to install, maintain and operate all kinds and types of machinery and appliances, and generally to perform all acts which may be deemed necessary or expedient for the proper and successful prosecution of the objects and purposes for which the corporation is created.

(f) In addition to the foregoing designated powers this corporation shall likewise enjoy all other corporate powers ordinarily conferred by the laws of the State of North Carolina.

<u>FOURTH</u>: The total authorized capital stock shall consist of ten thousand (10,000) shares of stock having a par value of Ten Dollars ($10.00) per share, or an aggregate total par value of One Hundred Thousand Dollars ($100,000.00); provided, however, that not in excess of 50% of such authorized capital stock may be issued as preferred stock of such character, preferences, dividend rates, redemption privileges and the like, as the stockholders may determine at the time or times of issuance.

The Corporation may begin business when 1500 shares of its capital stock, or an aggregate par value of $15,000.00, shall have been subscribed.

<u>FIFTH</u>: The names and post office addresses of the subscribers to the stock of this Corporation, and the number of shares subscribed for by each, the aggregate of which being the

amount with which this Corporation will commence business, are as follows:

NAME	POST OFFICE ADDRESS	NUMBER OF SHARES SUBSCRIBED
Thomas M. Stanback	Salisbury, N.C.	500
Fred J. Stanback	Salisbury, N.C.	500
James A. Lewis	Charlotte, N.C.	500

SIXTH: The period of existence of this Corporation shall be unlimited.

SEVENTH: The business and resources of this Corporation shall be managed and controlled by a Board of Directors and the said Board, by a majority vote of all their number, at any regular meeting or at any special meeting called for that purpose, shall have power to make, alter, amend and rescind the by-laws; and said Board shall likewise have the power and authority to fix from time to time the amount to be reserved as a working capital.

L. AND S. FURNITURE COMPANY

1. The present name of the Corporation is L. and S. FURNITURE COMPANY.

2. The Amendments adopted pursuant to G. S. Section 55-103 are as follows:

"RESOLVED that the Charter of the corporation be changed as follows:

"1. The name of the corporation shall be changed to 'FULTON CORPORATION'.

"2. The registered office of the corporation shall be 1500 South Main Street, Salisbury, Rowan County, North Carolina, and the registered agent at such address is Fred. J. Stanback.

"3. Paragraph 3 of the existing Charter relating to objects and purposes for which the corporation is formed shall be amended as follows:

By deleting subparagraph (f) and inserting a new paragraph (f) as follows:

'(a) To acquire and hold shares, stocks, debentures, debenture stocks, bonds, obligations, and securities issued or granted by any Company constituted or carrying on business in the United States, or in any colony, or dependency, or possession thereof or in any foreign country, and debentures, debenture stock, bonds, obligations, and securities issued or granted by any government, sovereign, ruler, commissioners, public body, or authority, supreme, municipal, local, or otherwise, whether at home or abroad.

'(b) To acquire any such shares, stocks, debentures, debenture stock, bonds, obligations, or securities by original subscriptions, tender, purchase, exchange, or otherwise, and to subscribe for the same, either conditionally, or to exercise and enforce all rights

and powers conferred by or incident to the ownership thereof.

`(c) To issue debentures, debenture stock, bonds, obligations, and securities of all kinds, and to frame, constitute, and secure the same, as may seem expedient, with full power to make the same transferable by delivery, or by instrument of transfer or otherwise, and either perpetual or terminable, and either redeemable or otherwise, and to charge or secure the same by trust deed or otherwise, on the undertaking of the Company, or upon any specific property rights present and future, of the Company (including, if thought fit, uncalled capital), or otherwise however.

`(d) To advance and lend money and assets of all kinds upon such terms as may be arranged.

`(e) To facilitate and encourage the creation, issue, or conversion of debentures, debenture stock, bonds, obligations, shares, stocks, and securities, and to act as trustees in connection with any such securities, and to take part in the conversion of business concerns and undertakings into companies.

`(f) To take part in the management, supervision, or control of the business or operations of any company or undertaking, and for that purpose to appoint and remunerate any directors, accountants, or other experts or agents.

`(g) To employ experts to investigate and examine into the conditions, prospects, value, character,

and circumstances of any business concerns and undertakings, and generally of any assets, property, or rights.'

"By adding a new subparagraph 3(g) as follows:

`To engage in any lawful activity permitted under the laws of the State of North Carolina'."

3. The above Amendments were adopted by unanimous vote of the stockholders on September 30, 1964.

4. There are ten thousand (10,000) shares of common stock outstanding, each of which was entitled to vote on the above Amendments.

5. All shares outstanding voted for the above Amendments.

6. The above Amendments do not give rise to dissenters' rights under G.S. 55-101(b).

This 30 day of September, 1964.

L & S FURNITURE COMPANY

By: /s/ Fred J. Stanback
Fred J. Stanback

ATTEST:

/s/ Fred J. Stanback, Jr.
Fred J. Stanback, Jr.

[Exhibit B, the 1990 Intangibles Tax Return of Fulton Corporation, is not reproduced here because the pertinent part appears with the Affidavit of J. D. Freeman above.]

Decision of the North Carolina Court of Appeals [this may be found in the Petition for Writ of Certiorari filed January 13, 1995, 18a-38a, Appendix B (note that the Secretary of Revenue is improperly designated there as Secretary of State)].

Decision of the Supreme Court of North Carolina to be reviewed [this may be found in the Petition for Writ of Certiorari filed January 13, 1995, 1a-17a. Appendix A].

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(4)

No. 94-1239

IN THE SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,

Respondent.

On Writ of Certiorari to the
Supreme Court of North Carolina

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether the North Carolina intangible personal property tax on the value of corporate stock owned by shareholders discriminates against interstate commerce in violation of the United States Constitution by taxing one hundred percent of the value of stock of corporations that do no business in North Carolina, but exempting from taxation the stock of corporations that do business only in North Carolina, and reducing the taxable value of the stock of other corporations proportionately as the amount of business done by the corporation in North Carolina increases.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, petitioner Fulton Corporation states that it has neither a corporate parent nor a corporate subsidiary.

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IN THE
SUPREME COURT OF THE UNITED STATES

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No. 94-1239

FULTON CORPORATION,
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V.

JANICE H. FAULKNER, SECRETARY OF REVENUE,
Respondent.

On Writ of Certiorari to the Supreme Court of North Carolina

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The Opinion of the Supreme Court of North Carolina (Pet. App. 1a-17a) is reported at 338 N.C. 472, 450 S. E. 2d 728 (1994). That opinion reversed the decision of the North Carolina Court of Appeals (Pet. App. 18a-35a), reported at 110 N.C. App. 493, 430 S.E. 2d 494 (1993).

JURISDICTION

The Supreme Court of North Carolina issued its opinion on December 9, 1994 and the clerk entered the judgment and issued the mandate of that court on December 29, 1994. The petition for a writ of certiorari was filed on January 13, 1995, and was granted on April 17, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article 1, Section 8, clause 3 of the United States Constitution provides in relevant part:

> The Congress shall have Power To . . . regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes; . . . .

Pertinent portions of the North Carolina taxing statutes appear in the Appendix to this Brief at 1a et seq.

STATEMENT OF FACTS

A. Procedural Background. Fulton Corporation (herein referred to as "Taxpayer"), a corporation chartered and domiciled in North Carolina, sued the North Carolina Secretary of Revenue in the North Carolina Superior Court for refund of taxes paid on stocks for 1990 and for declaratory judgment and attorneys' fees under 42 U.S.C. §§ 1983 and 1988, in May of 1991. The complaint asserted that N.C. Gen. Stat. § 105-203 violates the

Commerce Clause of the United States Constitution insofar as the statute imposes a property tax on some or all of the value of corporate stocks owned by Taxpayer. Joint App. 3. The trial court granted the Secretary of Revenue's summary judgment motion and denied Taxpayer's.

The North Carolina Court of Appeals on 15 June 1993 filed its unanimous opinion reversing the trial court's decision on the merits and remanding the cause for entry of a judgment declaring the intangibles tax provision at issue to be in violation of the Commerce Clause. *Fulton Corp. v. Justus*, 110 N.C. App. 493; Pet. App. 18a-35a. The Court of Appeals did not order refund of the taxes paid because it made its determination of unconstitutionality prospective only to the 1994 tax year (the opinion was issued in mid 1993).[1] Taxpayer sought review of the denial of refund and also of the Court of Appeals' denial of attorneys fees Taxpayer had sought under 42 U.S.C. §1988; the Secretary of Revenue sought review on the merits.

The Supreme Court of North Carolina agreed to review all issues raised by both parties, but did not reach the Taxpayer's issues because it reversed the decision of

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[1] The Court of Appeals cited as its ground for denying retrospective refund relief *Swanson v. State of North Carolina*, 329 N.C. 576, 581, 407 S.E.2d 791, 793 (1991), *vacated and remanded*, 113 S. Ct. 3025 (1993), *on remand*, 335 N.C. 674, 441 S.E.2d 537 (1994) (entering judgment for State), *cert. denied*, 115 S. Ct. 662 (1994). The Court of Appeals also selected as the prospective remedy to excise the deduction from N.C. Gen. Stat. § 105-203, relying on N.C. Gen. Stat. § 105-215. App. 12a.

the Court of Appeals on the merits, reinstating the decision of the Superior Court, and ruling that the North Carolina intangibles tax on stock does not violate the Commerce Clause. *Fulton Corp. v. Justus*, 338 N.C. 472; Pet. App. 1a-17a.

B. North Carolina Intangibles Tax Scheme. North Carolina imposes a property tax on the fair market value of certain financial intangibles, including corporate stock, owned by residents or arising from a non-resident's business in the State. N.C. Gen. Stat. §§ 105-203, 105-206; App. 9a, 10a. The tax is not imposed uniformly on the full fair market value of all stocks. Instead, the owners of the stock of certain corporations can deduct from the full value a percentage thereof, up to and including one hundred percent. [In this brief "corporation" refers to the corporation that issued the stock that is subject to the intangibles tax, and not to Fulton Corporation, which is referred to as "Taxpayer."]

The deduction is one hundred percent if one hundred percent of the business activities of a domestic corporation occurred within North Carolina in a specified earlier year. N.C. Gen. Stat. §§ 105-203(1), 105-130.7(1), 105-130.4; App. 9a, 8a, 1a. Examples would include incorporated purely local businesses such as corner drugstores, professional associations and the like. The stock of such corporations is free of intangibles tax.

No deduction from the full fair market value of the stock is allowed if the corporation is a foreign corporation that did no business in North Carolina in the specified earlier year. In addition to statutes cited in the preceding paragraph, *see* N.C. Gen. Stat. § 105-130.3 (under which

such a corporation is not subject to the state's corporate income tax); App. 1a. Examples are large national corporations such as Exxon Corp., GTE Corp. and Raytheon Corp. "Stock and Bond Values as of December 31, 1990" in Exhibit Notebook that is part of the Record on Appeal in the North Carolina Court of Appeals, 5 (footnote), 25, 29, 66.

In other cases the deduction is a percentage of the stock's value equal to the percentage indirectly determined by comparing the corporation's business activities in North Carolina with all of its business activities. Corporations in this latter category can be referred to as multistate corporations that do business in North Carolina. *See* N.C. Gen. Stat. § 105-130.4(b); App. 1a. While this group includes domestic North Carolina corporations that do some business outside the State, most commonly it includes large national corporations that do a small amount of business in the State, such as General Electric (1%) and IBM (5%). "Stock and Bond Values as of December 31, 1990," 30, 39.

The statute quantifies the percentage of a multistate corporation's business activities in North Carolina by use of the allocation and apportionment rules in the North Carolina corporate income tax. N.C. Gen. Stat. § 105-203(1), § 105-130.7(1), § 105-130.4; App. 9a, 8a, 1a. The allocation rules allocate to North Carolina all of the domestic corporation's nonbusiness income from certain passive investments (for example, interest and dividends received by a corporation whose commercial domicile is in North Carolina, and rents received from property located in North Carolina). N.C. Gen. Stat. § 105-130.4(c) - (h); App. 1a. The apportionment rules apportion to North

Carolina that part of a corporation's business income deemed earned in the State, determined by dividing each of its payroll, property and sales volume "factors" within the state by the totals thereof and averaging the three percentages, with the sales factor being double weighted. N.C. Gen. Stat. § 105-130.4(i) - (l); App. 4a - 8a.

In practice, shareholders determine their intangibles tax bases by multiplying the full value of their stock in a corporation by the corporation's "taxable percentage," which the Secretary of Revenue determines and publishes annually for a large number of corporations. For example, the taxable percentage for 1990 for General Electric was 99% and for IBM was 95%. "Stock and Bond Values as of December 31, 1990," 30, 39. See also "1990 Taxable Percentages," containing similar information for other stocks.

C. Application of the Intangibles Tax to Taxpayer. The North Carolina intangibles tax applied as follows to the stocks owned by Taxpayer on December 31, 1990. Most of Taxpayer's stocks were "100% taxable." Joint App. 11. This means that the corporations were neither domiciled in North Carolina nor did business in or earned income from North Carolina (and so were not subject to the North Carolina corporate income tax). Taxpayer was charged intangibles tax on 100% of the market value on December 31, 1990 of the stocks of such corporations. Taxpayer owned stock of one corporation that did part of its business in North Carolina, Food Lion, Inc. Its stock's taxable percentage was 54%, meaning that 46% of Food Lion's business was done in North Carolina (and 46% of its net income was subject to the North

Carolina corporate income tax). Joint App. 11; Record on Appeal in North Carolina Court of Appeals 17).

D. Proceedings Below. The North Carolina Court of Appeals ruled that the intangibles tax on stock facially discriminates against interstate commerce because "shareholders of out-of-state corporations are required to pay intangibles taxes on a higher percentage of shares [values] than shareholders of corporations operating solely in North Carolina." 110 N.C. App. at 499; Pet. App. 25a. The Court of Appeals recognized the applicability and violation of this Court's internal consistency test for Commerce Clause violations, which asks whether the state's tax regime, if adopted by all states, would necessarily result in discrimination against interstate commerce. The Court of Appeals rejected the Secretary of Revenue's argument that the property tax imposed on stock was a "compensating tax" designed to make interstate commerce bear a burden already borne by intrastate commerce in the form of the corporate income tax.

Finally, the Court of Appeals distinguished the 1912 decision of this Court in *Darnell* because it involved a property tax on stock that treated the stock as embodying the corporate property, which also was subject to the state's property tax; the Court of Appeals found no similar effort by North Carolina to tax property value once. *Darnell v. Indiana*, 226 U.S. 390 (1912).

On appeal from the Court of Appeals, the Supreme Court of North Carolina did not dispute the facial discrimination of the North Carolina intangibles tax, but found that the *Darnell* decision controlled and

furthermore that *Darnell* compelled it to accept the Secretary's compensating tax defense to the facial discrimination. The Supreme Court of North Carolina ignored this Court's internal consistency test and the discrimination it illustrates.

E. Subsequent Event. Subsequent to this Court's grant of its writ of certiorari, the North Carolina General Assembly repealed the intangibles tax for returns due in 1996. 1995 N.C. Sess. Laws Ch. 41; App. 15a. This repeal does not affect the tax year at issue in this case or Taxpayer's refund claim, which remain unsatisfied (as do the refund claims of the Taxpayer for other years for which a separate suit has been brought, and the refund claims of thousands of similarly situated North Carolina taxpayers for 1991, 1992, 1993 and 1994 taxes). Taxpayer made its refund claim under N.C. Gen. Stat. § 105-267, the only avenue allowed by the North Carolina courts for a taxpayer to contest an illegal tax. App. 14a. Therefore, the case is neither moot nor is the importance of the legal issues upon which this Court issued its writ of certiorari diminished.[2]

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[2] The case is not moot so long as the parties have a concrete interest in the outcome of the action, however small. *See University of Texas v. Camenisch*, 451 U.S. 390 (1981); *Powell v. McCormack*, 395 U.S. 486, 495-500 (1969); *Ellis v. Brotherhood of Clerks*, 466 U.S. 435 (1984) (not moot where claim for damages remained); *Board of Pardons v. Allen*, 482 U.S. 369, 370 n. 1 (1987) (remaining claims for damages prevented mootness). Furthermore, the significance of the issue on which this Court granted its writ continues. The instant case is distinguishable from perhaps the classic case in which this Court discussed dismissal of a previously granted writ, wherein the state adopted a statute that precluded any future enforcement of the offensive cemetery contract terms at issue in the case, so that similarly situated plaintiffs in any other case arising in the future would be entitled to damages. *Rice v. Sioux City Memorial Park Cemetery*, 349 U.S. 70 (1955). Here Fulton Corp. and other North Carolina taxpayers have pursued and can pursue refund of these illegal taxes and have been and will be denied those refunds on the basis of the decision of the Supreme Court of North Carolina in the instant case.

The Supreme Court of North Carolina did not reach the erroneous conclusion of the North Carolina Court of Appeals that its determination of unconstitutionality was prospective only, which permitted the Court of Appeals to deny the Taxpayer's demand for refund. Taxpayer assumes that remedial issues will be decided by the North Carolina Supreme Court on remand from this Court, unless this Court directs their resolution on its own motion.[3]

SUMMARY OF ARGUMENT

A. A state tax that facially discriminates against interstate commerce is presumptively invalid under the Commerce Clause.

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[3] *Cf. Swanson v. State of North Carolina*, 329 N.C. 576, 581, 407 S.E. 2d 791, 793 (1991), *vacated and remanded*, 113 S. Ct. 3025 (1993), *on remand*, 335 N.C. 674 (1994) (entering judgment for State), *cert. denied*, 115 S. Ct. 662 (1994) (illustrating the difficulties the North Carolina courts have imposed in the way of refunds of taxes ruled unconstitutional by this Court). *See also* N.C. Gen. Stat. § 105-216, App. 13a, which exacerbates the difficulties here by providing that the intangibles tax will revert to being a local tax if held illegal at the state level.

B. N.C. Gen. Stat. §105-203(1) facially discriminates against interstate commerce by reducing the tax base of the intangibles tax on stock by a percentage of the stock value equaling the percentage of the corporation's income that is subject to income tax in North Carolina. That discrimination disfavors interstate commerce and favors local commerce because the percentage of deduction increases with an increase in the amount of business and contacts of the corporation with North Carolina.

C. The facial discrimination cannot be overcome by a compensating tax defense, based on *Darnell v. Indiana*, or otherwise. The intangible tax either discriminates against interstate commerce, or unconstitutionally attempts to tax income the corporation earns outside of North Carolina, or both.

1. The Supreme Court of North Carolina incorrectly determined that the application of the compensating tax defense was controlled by *Darnell v. Indiana*, 226 U.S. 390. That case is factually distinguishable in that it involved an Indiana property tax on 100% of the value of stock, which was applied to stock of an Indiana corporation by allowing the shareholder an offset against taxable stock value in the amount of the value of the corporate property taxed in Indiana.

In contrast, the instant case involves North Carolina property tax on a percentage of the value of corporate stock which percentage decreases as the percentage of the corporation's *income* that is taxed in North Carolina increases. In effect, the North Carolina stock tax is not imposed on property but rather is imposed

indirectly on the part of the corporate income that North Carolina is not constitutionally entitled to tax because it is earned out of the State.

2. Moreover, *Darnell* did not involve a successful compensatory tax defense. It simply involved a stock tax with an offset. There was no intrastate burden for which the stock tax compensated because all property of foreign and domestic corporations that was subject to property tax in Indiana was taxed by Indiana.

3. In any event, the North Carolina scheme fails each of the three requirements of the compensatory tax defense. First, the tax on stock does not compensate for any burden borne by intrastate commerce that interstate commerce *improperly* avoids. Moreover, the compensating tax defense requires substantial equality of taxation of the local and interstate commerce, based on a comparison of equivalent tax bases and equivalent rates. Here there are neither comparable tax bases nor equivalent rates and the taxes do not fall on substantially equivalent events.

D. The North Carolina scheme for taxing stock values and corporate income (which are caused to be interrelated by statute) fails the internal consistency test, even if the intangibles tax could be a compensatory tax.

1. This Court requires that even a taxing scheme that appears to involve equivalent compensating taxes be tested for internal consistency under the Commerce Clause. Internal consistency requires that the application of the North Carolina taxing scheme by all states would not necessarily produce multiple taxation of

or on account of interstate commerce as compared with local commerce.

2. The North Carolina scheme of intangibles and corporate income taxation, if applied by all states, would result in corporations paying tax on about 100% of their incomes in the aggregate to all states in which they do business, and shareholders paying zero intangibles tax if they reside in the same state with their corporation that does business only in that state; but to any extent that the shareholders reside in a state where the corporation does not do all of its business, some intangibles tax will be due. Thus more aggregate tax is due on account of shareholding across state lines, or on account of the corporation doing business in interstate commerce.

3. Although *Darnell* may be distinguished rather than overruled, the tax scheme there at issue also failed the internal consistency test by taxing more heavily the shareholders of multi-state corporations.

ARGUMENT

THE FACIALLY DISCRIMINATORY INTANGIBLES TAX ON STOCK VIOLATES THE COMMERCE CLAUSE.

A. State Tax Laws That Discriminate Against Interstate Commerce on Their Face Are Presumptively Invalid Under the Commerce Clause.

Discrimination against interstate commerce both is forbidden by one part of the four part test for compliance of state taxes with the Commerce Clause articulated by *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, *reh'g denied*, 430 U.S. 976 (1977) (the other parts requiring substantial nexus of the taxpayer with the taxing state, fair apportionment of taxes and fair relationship of taxes to the services provided by the state), and continues to be viewed by this Court as the evil at which the Commerce Clause is generally aimed. *See Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984) (grounding the decision on discrimination against interstate commerce and not the four part *Complete Auto* test); *Welton v. Missouri*, 91 U.S. 275 (1876) (one of the earliest Commerce Clause cases, invalidating as discriminatory a license fee imposed on peddlers of out-of-state goods).

Such discrimination exists when the state tax statute treats a transaction differently because of some interstate element. *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 332 n.12 (1977). "That is, a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state." *Armco Inc. v. Hardesty*, 467 U.S. at 642. This Court has recently summarized the definition of discrimination in *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1344-1345 (1995) to include providing a direct commercial advantage to local business so as to discriminate against foreign enterprises that might compete with local businesses, and discriminating against commercial activity occurring outside the taxing state. *See also Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 406 (1984) (stating that a tax scheme should not foreclose "tax-neutral decisions. . . ."; finding

discrimination in limitation of a tax credit to receipts from shipment only from New York).

Facial discrimination against interstate commerce by a taxing statute is sufficient to void a statute under the Commerce Clause. *Memphis Steam Laundry Cleaners, Inc. v. Stone*, 342 U.S. 389, 395 (1952) (stating that a state tax statute is constitutional only if "no discrimination against interstate commerce appears either upon the face of the tax laws or in their practical operation."); *Armco Inc. v. Hardesty*, 467 U.S. at 642 (finding to be facially discriminatory differential taxation depending on whether the taxpayer conducts manufacturing in or out of the state); *Associated Indus. of Mo. v. Lohman*, 114 S. Ct. 1815, 1820 (1994) ("we ... have applied a 'virtually *per se* rule of invalidity' to provisions that patently discriminate against interstate trade"). *Cf. Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue*, 112 S.Ct. 2365, 2368 (1992) (stating in analogous "foreign commerce clause" case that the test is also facial discrimination).

Where facial discrimination exists, proof of discriminatory effect or impact is not required, in contrast with cases where there is no facial discrimination but the taxpayer attempts to prove discrimination in practical operation of a statute. *See Memphis Steam Laundry Cleaners, Inc. v. Stone*, 342 U.S. at 395 (identifying this alternative way to prove discrimination); *Best & Co. v. Maxwell*, 311 U.S. 454 (1940) (finding tendency to discriminate in the practical effects of a facially nondiscriminatory North Carolina tax, but without requiring any proof of actual discrimination); *Armco Inc. v. Hardesty*, 467 U.S. at 644 (analogizing the fair

apportionment test to the nondiscrimination test in terms of not requiring the taxpayer to prove actual discriminatory impact).

Furthermore, there is no requirement that a state, its legislature, or responsible officials have the intent to harm interstate commerce in order for a facially discriminatory state tax to be voided under the Commerce Clause. *Associated Indus. of Mo. v. Lohman*, 114 S. Ct. at 1824; *James B. Hunt, Jr. v. Washington State Apple Advertising Comm'n*, 432 U.S. 333, 352 (1977) ("we need not ascribe an economic protection motive to the North Carolina Legislature to resolve this case; . . .").

Accordingly, a state taxing statute is presumptively invalid when by its terms it imposes relatively heavier taxation on account of interstate elements.

B. The North Carolina Intangibles Tax Facially Discriminates Against Interstate Commerce.

N.C. Gen. Stat. §105-203(1), App. 9a, facially discriminates against interstate commerce by *only* taxing the stock of corporations that either engage in interstate commerce or do no business in North Carolina.

It accomplishes this result by allowing a deduction from full value in computing the taxable stock value base. That deduction increases as the North Carolina business activities and contacts of the corporation increase (North Carolina employees, property, sales, commercial domicile, etc.); the deduction decreases as those local contacts and business decrease. Thus, the value of stocks of more "local" corporations that engage less in interstate

commerce is taxed more lightly than the value of stocks of more "national" corporations that engage more in interstate commerce. The stock tax thus discriminates against interstate commerce of the corporation, against interstate commerce in the stock of those corporations, against shareholders who own corporations that engage, and engage more, in interstate commerce, and against such corporations.[4]

This facial discrimination is analogous to discrimination found in *Armco Inc. v. Hardesty*, 467 U.S. 638 and *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 240 (1987) where facial discrimination occurred in the exemptions of taxpayers from one tax because the taxpayers were subject to

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[4] While not necessary to a determination of facial discrimination, observe that the North Carolina tax scheme has the tendency to encourage North Carolina investors to buy stock in local corporations (such as Carolina Power and Light, Duke Power, Jefferson Pilot, etc., which are listed in the "Stock and Bond Values" exhibit as taxable 30%, 16%, and 1% respectively), rather than in corporations with more multistate activity, because the local stocks are taxed less or not at all. This has a tendency to affect the ability of out-of-state corporations to raise capital in interstate commerce by lessening the attractiveness of such stocks to buyers in this State. *See* Affidavit of Robert Gibbs Smith; Joint App. 13. In addition, the taxing scheme has the tendency to discourage local corporations from entering interstate commerce, which action would result in a higher percentage of their stocks' value being subject to the intangibles tax on their North Carolina shareholders, without reducing the corporation's nationwide income tax exposure.

another tax based on the taxpayers' activity in the state.[5] It also has the same tendency as the facially discriminatory Severance Tax Credits in *Maryland v. Louisiana*, 451 U.S. 725, 757 (1981), to encourage North Carolina corporations to invest in North Carolina business rather than to invest in business in other states. *See also, American Trucking Ass'ns. Inc. v. Scheiner*, 483 U.S. 266, 286-287 (1987) (stating that a disparate tax burden "has a forbidden impact on interstate commerce because it exerts an inexorable hydraulic pressure on interstate commerce to ply their trade within the State that enacted the measure rather than 'among the several States.' U.S. Const., Art. 1, §8, cl. 3.").

North Carolina could have avoided the discrimination either by not allowing a deduction based on the corporation's North Carolina income tax (and thus taxing 100% of the value of all stock) or by not taxing stock value, which in effect would approximate allowing a deduction for the percentage of the corporation's income taxed nationwide (*i.e.*, 100%).[6]

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[5] *See Armco*, 467 U.S. at 642 (quoting Justice Goldberg's dissent in *General Motors Corp. v. Washington* as source for this view of facial discrimination).

[6] *Cf. Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. at 1342 n. 6 (stating that a state need not credit sales tax paid by buyer against gross receipts tax paid by seller, but if it chose to do so for taxes paid to that state, it must extend credit to sales tax paid to other states).

C. The Facial Discrimination Cannot Be Overcome By A Compensating Tax Defense.

The North Carolina Supreme Court based its rejection of the Commerce Clause's application entirely on the Secretary's argument that the intangibles stock tax is a compensating tax for the corporate income tax, allegedly removing in effect the facial discrimination in the intangibles tax, relying on *Darnell v. Indiana*, 226 U.S. 390. The North Carolina Supreme Court argued that the intangibles tax is a proper compensating tax for the income tax that North Carolina imposes on corporations, because the income tax cannot reach corporations that do no business in North Carolina, or the income from the part of the business done outside North Carolina. Pet. App. 11a. North Carolina, however, has no right to be compensated for that income tax.

A facially discriminatory tax can be consistent with the Commerce Clause if it is designed simply to make interstate commerce bear an appropriate burden already borne by intrastate commerce. *See Associated Indus. of Mo. v. Lohman*, 114 S. Ct. at 1821. There is no evidence that the taxing regime at issue here is based on any such design.[7]

The classic example of a compensating tax is the use tax, which imposes on the purchase price of goods purchased in interstate commerce the same rate of tax that the sales tax imposes only with respect to the purchase price of locally purchased goods. The use tax appears to

[7]See deposition of Frank Goodrum, Jr. pp. 28-29 (disavowing the existence of any expressed aim of the statutory scheme).

discriminate against interstate commerce because it is limited to goods that have been brought or moved in interstate commerce. However, the sales tax corrects in effect the facial discrimination of the use tax by imposing an equivalent tax on the goods bought in the state. *See Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937); *Oregon Waste Sys., Inc. v. Dep't of Env. Quality*, 114 S. Ct. 1345, 1353 (1994) (stating that the only successful use of the compensating tax defense in recent memory is the case of the sales and use taxes). Each of the sales and use taxes are appropriately levied because each taxes consumption of the goods in the state, deemed to occur upon delivery within the state or use in the state.

1. *Darnell* is not controlling.

The Supreme Court of North Carolina felt bound by *Darnell*. That decision, however, is factually distinguishable. It involved a tax on stock value imposed on shareholders of domestic Indiana corporations, with a reduction in the tax base dollar-for-dollar as the domestic corporation's property tax base in the State increased. Shareholders of foreign corporations paid property tax on 100% of the value of their stock whether or not the corporation owned property in Indiana. Mr. Darnell owned stock of a Tennessee corporation that did not have property located in Indiana. The *Darnell* opinion strongly indicated that the Indiana statute was discriminatory because it failed to allow a similar reduction for property of foreign corporations taxed in Indiana, but did not have

to resolve that issue as it was not presented by the facts of the case.[8]

Thus, *Darnell* principally stands for the proposition that the shareholder's state of residence can tax 100% of the value of stock owned. *See First Bank Stock Corp. v. State of Minnesota,* 301 U.S. 234, 240 (1937) (citing *Darnell* for power of state of shareholder's residence to tax stock value). That tax used a prepayment of the shareholder level tax by the corporation.

Darnell is not controlling because North Carolina's tax scheme substantially differs from that Indiana scheme. The North Carolina taxing statutes make no effort to tax only once the value of stock. Instead, it interrelates the corporate income tax and the shareholder's property tax in a discriminatory fashion, as illustrated above.

2. Moreover, *Darnell* did not involve a successful compensatory tax defense.

The Supreme Court of North Carolina viewed *Darnell* as involving a successful compensatory tax defense. Pet. App. 11a. This is incorrect. This Court has

[8] Justice Holmes stated: "The most serious aspect of this objection is that the statutes of Indiana do not make allowances if a foreign corporation has property taxed within the state. But, as to this, it is enough to say that, however the statutes may be construed in a case of that sort, the plaintiffs in error do not show that it is theirs, and that, as they do not belong to the class for whose sake the constitutional protection would be given, if it would, they cannot complain on that ground." 226 U.S. at 398.

never cited the *Darnell* case as a compensatory tax case. *See also* Walter Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405 (1986) (containing an exhaustive study of compensating tax doctrine, but not citing *Darnell*). The defense is superficially similar to *Darnell's* facts in that they both involve an interrelationship between two taxes, but *Darnell* simply used the corporate property tax as a prepayment of the shareholder's property tax. *Cf. Maryland v. Louisiana,* 451 U.S. at 759 ("Of course, it [the Louisiana First Use Tax] does equalize the tax burdens on OCS gas leaving the State and Louisiana gas going into the interstate market. But this sort of equalization is not the kind of 'compensatory' effect that our cases have recognized.")

Darnell could not involve a compensatory tax because it did not satisfy the threshold requirement of the compensatory tax analysis, discussed in section 3 below: that there be an intrastate tax burden borne by intrastate commerce that the state is entitled to impose on interstate commerce by way of the compensating tax. Indiana was not taxing the stock of foreign corporations because it needed a way to tax the out-of-state property of foreign corporations. Rather, it was taxing 100% of all stock of residents because it had the power to do so, and it allowed a credit or prepayment of taxes paid by a related party - the domestic corporation - and should have allowed a credit for Indiana property tax paid by a foreign corporation.[9]

[9] See footnote 8, *supra.*

3. The North Carolina scheme fails each step of the compensatory tax analysis.

Oregon Waste Sys., Inc. v. Dep't of Env. Quality, 114 S. Ct. at 1352, set forth the three steps required to prove a compensatory tax defense. First, the state must identify the burden on intrastate commerce that is being *improperly* avoided by interstate commerce: ". . . as a threshold matter, 'identif[y] . . . the [intrastate tax] burden for which the State is attempting to compensate.'" 114 S. Ct. at 1352. Second, the compensatory tax and the intrastate tax must be equivalent. Third, the two taxes must fall on substantially equivalent events. *See also Associated Indus. of Mo. v. Lohman*, 114 S.Ct. at 1821 (also outlining the three step analysis).

The Supreme Court of North Carolina found the shareholder's property tax to compensate for the inability of the State to tax the income of the corporation earned out-of-state. Pet. App. 11a. But North Carolina has no right to tax the corporate income earned out-of-state. There is here no tax that the in-stater is paying but the out-of-stater is not paying for which compensation is needed. This Court made essentially the same observation in *Maryland v. Louisiana:*

> In our view, the First-Use tax cannot be justified as a compensatory tax. The concept of a compensatory tax first requires identification of a burden for which the State is attempting to compensate. Here, Louisiana claims that the First-Use tax compensates for the effect of the State's severance tax on local production of natural gas. To be sure, Louisiana has an interest in protecting

> its natural resources, and, like most states, has chosen to impose a severance tax on the privilege of receiving resources from its soil. . . . ***But, the First-Use tax is not designed to meet these same ends since Louisiana has no sovereign interest in being compensated for the severance of resources from federally owned OCS land.*** [emphasis added]

Maryland v. Louisiana, 451 U.S. at 759.

In contrast, the properly compensatory sales and use taxes are both imposed on an event that the state has the power to tax: the use or consumption in the state of the property, irrespective of whether it is acquired within the state or from another state. *Associated Industries* stated:

> Cf. *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 66, 83 S.Ct. 1201, 1202, 10 L. Ed. 2d 202 (1963) ("[T]he purpose of such a sales-use tax scheme is to make all tangible property used or consumed in the State subject to a uniform tax burden irrespective of whether it is acquired within the State . . . or from without the State").

Associated Indus. of Mo. v. Lohman, 114 S.Ct. at 1821.

Maryland v. Louisiana also made this point by focusing on the consumption in the state, which is the jurisdictional nexus for both the sales and use tax:

> . . . the two events [the severance of oil from Louisiana lands and the severance of oil from federally owned OCS land] are not comparable in

> the same fashion as a use tax complements a sales tax. In that case, a state is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials *to be consumed in the state*. No such equality exists in this instance. [emphasis added]

Maryland v. Louisiana, 451 U.S. at 759.

See also Henneford v. Silas Mason Co., 300 U.S. 577, 584 (1937) ("No one who uses property in Washington after buying it at retail is to be exempt from a tax upon the privilege of enjoyment except to the extent that he has paid a use or sales tax somewhere."); *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. at 1343 (identifying local activity as basis for taxing power and stating that a credit against the use tax would be required for sales tax paid to another state on the same goods).

Even if somehow the intangibles and corporate income taxes could be viewed as possibly compensatory, there is no sort of equivalence between the two taxes, and so the second and third requirements for a compensating tax also are lacking. While the income of a corporation may or may not bear some relationship to its stock value, that does not prove that taxing one corporation's income results in equal treatment (*i.e.*, the same total taxation) with taxing another corporation's shareholders on their stock.

This Court has recently discussed the practical implementation of the compensating tax defense in *Associated Indus. of Mo. v. Lohman*, 114 S. Ct. 1815. It rejected Missouri's asserted compensating tax defense

because any equivalence of sales and use tax "is a matter of fortuity, ... " that did not comply with the "strict rule of equality adopted in *Silas Mason*." 114 S. Ct. at 1821. Even though the differential in sales and use taxes in Missouri was in many cases quite small, this Court applied its view that "the magnitude and scope of the discrimination have no bearing on the determinative question whether discrimination has occurred." 114 S. Ct. at 1822.

Furthermore, this Court distinguished as "bypassed by later decisions" an earlier decision that upheld a tax even though it did not tax in and out-of-state commerce with mathematical exactness; that is, " 'close enough for government work' . . . never took root in our Commerce Clause jurisprudence" but instead, the "strict rule of equality . . . has controlled compensatory tax cases for over half a century." 114 S. Ct. at 1823. This Court required that the tax on the intra and interstate transaction be in "the *same amount*." 114 S. Ct. at 1823.

The *Associated Industries* opinion made another pertinent point, stating that courts should not "plunge . . . into the morass of weighing comparative tax burdens," but rather should normally limit themselves to looking for equivalent rates on substantially equivalent events and not be "drawn into an amorphous inquiry that involves balancing incommensurate burdens imposed on disparate activities throughout the complex structure of a State's tax system." 114 S. Ct. at 1825 n. 5. The opinion of the Supreme Court of North Carolina plunges into exactly that sort of morass. Its offer of proof (which was not argued by the Secretary) involved the truism that given a top North Carolina corporate income tax rate of 7.75% and an

intangibles tax rate of 25 cents per hundred dollars of stock value, a corporation would have to have a price/earnings ratio in excess of 31 for the intangibles tax to exceed the corporate income tax. Pet. App. 13a-14a.

This observation entirely misses the point. Under the North Carolina Supreme Court's example, the Virginia corporation doing business only in Virginia will pay corporate income tax to Virginia at 7.75% (assuming the same corporate income tax rate as North Carolina imposes) and the similar North Carolina corporation doing business only in North Carolina will pay the same corporate income tax to North Carolina. If, however, the shareholders of both corporations are North Carolina residents subject to the North Carolina intangibles tax, the Virginia corporation's shareholders will be taxed and the North Carolina shareholders will not be taxed. Therefore, the aggregate taxation of the shareholder-corporation unit in the United States will increase as stock is held across state lines, even if the price/earnings ratio of the corporation is only 1:1, much less 31:1. This fact illustrates the violation of internal consistency described in Section D below, which the Supreme Court of North Carolina totally ignored.

Furthermore, the North Carolina scheme fails the third requirement for a compensating tax - that the tax must be imposed on a "substantially equivalent event" that produces substantially uniform taxation of intrastate and interstate commerce - even if the threshold issue of the inability of North Carolina to tax corporate income earned out-of-state could be ignored, and if the corporate income and shareholder intangibles taxes were equal (which they are not). *See generally Associated Indus. of*

Mo. v. Lohman, 114 S. Ct. 1815. A tax may be considered a compensating tax when "[the] State is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials to be consumed in the State." *Maryland v. Louisiana*, 451 U.S. at 759 (rejecting Louisiana's attempt to link a severance tax on gas with a "first use" tax on gas).

The requirement of substantially equivalent events reconfirms the threshold point above, that the compensating tax must compensate for the inability to tax an event the state *has the power to tax*. Without that, the events or tax bases cannot be substantially equivalent.

Furthermore, a shareholder's ownership of stock and a corporation's receipt of income cannot be "substantially equivalent events" in any other sense. The intangibles tax is not paid by the same class of taxpayer as the tax purportedly being compensated for and would not be paid upon the same amount or at the same rate (again, unlike the sales/use tax case).

The two "events" that the Secretary attempts to link are even more unrelated than other linkages this Court has rejected. In *Armco Inc. v. Hardesty*, 467 U.S. 638, this Court addressed the constitutionality of West Virginia's business and occupation tax. There, plaintiff, an Ohio corporation engaged in the business of manufacturing [outside West Virginia] and selling steel products in West Virginia, challenged on Commerce Clause grounds the constitutionality of West Virginia's tax requiring persons engaged in the business of selling tangible property at wholesale to pay taxes on gross receipts. Local manufacturers were exempt from the gross receipts tax;

however, they were required to pay a higher manufacturing tax. This Court found the gross receipts tax unconstitutional, rejecting West Virginia's argument that the higher manufacturing tax was a compensating tax for the gross receipt tax. The Court held:

> [M]anufacturing and wholesaling are not "substantially equivalent events" such that the heavy tax on in-state manufacturers can be said to compensate for the admittedly lighter burden placed on wholesalers from out of State. Manufacturing frequently entails selling in the State, but we cannot say which portion of the manufacturing tax is attributable to manufacturing, and which portion to sales. The fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State, and that it is reduced when part of the manufacturing takes place out of State, makes clear that the manufacturing tax is just that, and not in part a proxy for the gross receipts tax imposed on Armco and other sellers from other States.

467 U.S. at 643.

D. The North Carolina Tax On Stock Values Fails the Internal Consistency Test, Even If the Intangibles Tax Could be a Compensatory Tax.

1. The North Carolina Supreme Court improperly ignored this Court's requirement that the taxing scheme be internally consistent.

The Supreme Court of North Carolina stopped its analysis with its erroneous decision that *Darnell* controls. This Court, however, requires that an internal consistency test be applied in Commerce Clause cases as a method of identifying discrimination against interstate commerce:

> Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear.

Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. at 1338. *See also Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. at 159; *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (ruling that facially nondiscriminatory flat taxes on trucks failed the internal consistency test); *Armco Inc. v. Hardesty*, 467 U.S. 638; *Tyler Pipe Indus. v. Wash. Dep't of Revenue*, 483 U.S. 232; *Goldberg v. Sweet*, 488 U.S. 252 (1989); *Ashland Oil, Inc. v. Caryl*, 497 U.S. 916 (stating also that *Armco* extended the internal consistency test doctrine beyond the context in which it had originated) .

When applied to a facially discriminatory tax, the test supplants any requirement that the plaintiff prove the tax had actual discriminatory impact. *See Tyler Pipe Indus. v. Wash. Dep't of Revenue*, 483 U.S. 232, at 240-241 (observing that *Armco* had struck down a tax that actually imposed a heavier burden on local manufacturers), and at 257 (dissent of Scalia); *Jefferson Lines*, 115 S. Ct. at 1338 ("This test asks nothing about the degree of economic reality reflected by the tax . . . .").

This Court addressed the relationship of the compensating tax defense to the internal consistency test in *Armco Inc. v. Hardesty*, 467 U.S. at 642-643 and *Tyler Pipe*, 483 U.S. at 240-247. In both of those cases the Court first identified a facial discrimination, then assessed a compensating tax defense and found it wanting, but went on to find that in any event the taxing scheme was internally inconsistent and thus also invalid for that reason. The fact that one of the taxes to be evaluated under the internal consistency test, the intangible personal property tax, attaches only to a "local" activity (stockholding by residents and business situs stockholding) does not immunize it from Commerce Clause scrutiny. *See generally Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 615 (1981).

2. Internal consistency is lacking in the North Carolina taxing regime.

Because North Carolina has chosen to link the taxation of shareholders' stock and corporate income, these two taxes necessarily comprise the taxing regime at issue. *Cf. Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. at 1342 n. 6 (1995) (assuming that a gross receipts tax on a seller and a sales tax on a buyer comprise a taxing regime to be evaluated together under the Commerce Clause, when a state's statutes cause the two taxes to be interdependent).

In summary, if all states adopted North Carolina's taxing regime, more tax would be owed when either the corporation enters into interstate commerce or when shareholding crosses state lines away from where the corporation does business.

Increased tax when corporation engages in interstate commerce. For example, suppose Corporation X does business only in North Carolina and so will pay tax there on 100% of its income under the North Carolina income tax. N.C. Gen. Stat. § 105-130.3; App. 1a. Its shareholders will pay no intangibles tax, due to the discriminatory deduction at issue in this case, if they all reside in North Carolina. N.C. Gen. Stat. § 105-203(1); App. 9a. Corporation X will still pay income tax on about 100% of its income under the North Carolina corporate income tax as applied by all states if it enters into interstate commerce and does half of its business in Virginia: about half of its income will be taxed by each of North Carolina and Virginia. In that event, however, its shareholders resident in North Carolina will pay intangibles tax on half of the value of their stock (a proxy for the half of the corporate income that North Carolina cannot constitutionally tax). Thus, Corporation X causes an increase in the aggregate taxation of itself and its shareholders by entering into interstate commerce.

Increased tax when shareholding crosses state lines. Again suppose Corporation X does all of its business in North Carolina and all its shareholders reside there. Corporation X pays tax on 100% of its income and its shareholders pay no intangibles tax. When, however, a shareholder sells his or her stock to a resident of Virginia, that new shareholder will pay Virginia intangibles tax on 100% of stock value, if the North Carolina taxing regime were adopted by all states. Thus, shareholding across state lines from the state where the corporation does its business also causes an increase in aggregate taxation under the North Carolina regime.

The increased taxation caused by interstate elements under the North Carolina tax scheme is directly analogous to that caused when an Ohio manufacturer sold into West Virginia, as described in *Armco Inc. v. Hardesty*, 467 U.S. at 644. It would pay manufacturing tax to Ohio and wholesaling tax to West Virginia while the West Virginia manufacturer selling in West Virginia would only pay the West Virginia manufacturing tax.

North Carolina created this discrimination by attempting to favor local corporations through the deductions at issue here. No discrimination would exist if North Carolina either (a) taxed all of the value of stock owned by its residents (which was the prospective remedy ordered by the North Carolina Court of Appeals in this case), or (b) imposed no tax on stock (which is the remedy by refund sought by Taxpayer and is the prospective "remedy" ordered by the North Carolina General Assembly in repealing the tax for future returns), which would approximate the result of giving a deduction for the percentage of the income of the corporation that is taxed by all states, i.e., 100%.[10]

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[10] The fact that the intangibles and corporate income taxes are imposed on different taxpayers does not change the internal consistency analysis. This Court identified, but expressed no opinion on, a related question in fn. 6 of its opinion in *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. at 1342, referencing *Darnell v. Indiana*. In the same footnote the Court evaluated the total tax burden on a seller paying gross receipts tax and an *unrelated* buyer paying sales tax. Surely a credit allowed to one taxpayer for tax paid by a *related* taxpayer to State A will be discriminatory if credit is not also allowed for the *related* taxpayer's tax paid to State B. *See S.C. State Hwy. Dep't v. Barnwell Bros.*, 303 U.S. 177, 185 (1938) ("The commerce clause by its own force, prohibits

3. *Darnell* also would fail today's internal consistency analysis.

Darnell is factually distinguishable and therefore, the Court need not overrule it to hold for Taxpayer here. As a matter of completeness, however, one must observe that *Darnell* cannot withstand modern internal consistency analysis (just as many older cases could not withstand analysis under *Complete Auto Transit, Inc.*).

The statutory scheme in *Darnell*, if applied by all states, would tax corporations on 100% of their property value in the aggregate nationwide, and would tax shareholders on 100% of their stock value only if the corporation owned no property in the state where the shareholder resided.[11] Thus, shareholding across state lines from where the corporation operates creates the maximum aggregate property tax.

As the value of corporate property owned in the state increases, the taxable value of the shareholders' stock decreases and will reach zero when all of the corporation's property is located in the state where the shareholder resides. Thus, the taxing regime encourages the corporation to "stay at home" and not to do business

---

discrimination against interstate commerce, whatever its form or method, ...").

[11] This assumes shareholders of foreign corporations would also be allowed an offset for the value of corporate property owned in the state.

in interstate commerce. The 1912 decision in *Darnell* dealt only elliptically with this issue, relying on analysis in a case brought under the Fourteenth Amendment, which permits multiple taxation.[12]

Within just the last year and a half this Court has twice observed that states cannot ignore taxes paid to other states in Commerce Clause cases. In *Oregon Waste Sys., Inc. v. Dep't of Env. Quality*, 114 S. Ct. 1345, Oregon argued that local companies paid local income taxes that compensated for the special tax on foreign waste. The opinion's footnote 7 observed:

> We would note that respondents, like the dissent, *post*, at 1357, ignore the fact that shippers of waste from other states in all likelihood pay income taxes in other states, a portion of which might well be used to pay for waste reduction activities in those states.

114 S. Ct. at 1353.

Similarly, footnote 6 of *Jefferson Lines, Inc.*, 115 S. Ct. at 1342, states that once a state decides to credit the buyer's sales tax against the seller's gross receipts tax, the state cannot limit that credit to sales tax it collected but must extend the credit to "sales taxes paid to any state."

---

[12] *Darnell*, 260 U.S. at 398 (referring to *Kidd v. Alabama*). *See Curry v. McCanless*, 307 U.S. 357 (1939) (ruling that Due Process Clause does not forbid multiple taxation by states). *See also* Pet. 11-12.

Consequently, the *Darnell* taxing regime would not be allowed to stand today (which perhaps is why Indiana has repealed it).

CONCLUSION

The North Carolina intangibles tax on stock paid by Taxpayer violates the Commerce Clause and Taxpayer is entitled at minimum to declaration of that fact and to remand directing the North Carolina Supreme Court to grant a remedy to remove the discrimination. That remedy should be a refund of all tax paid on stock by Taxpayer for 1990.

Respectfully submitted,

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APPENDIX

CONTENTS OF APPENDIX

N.C. Gen. Stat. § 105-130.3. Corporations.

A tax is imposed on the State net income of every C Corporation doing business in this State at seven and seventy-five one-hundredths percent (7.75%) of the corporation's State net income.

N.C. Gen. Stat. § 105-130.4. Allocation and apportionment of income for corporations.

(a) As used in this section, unless the context otherwise requires:

* * *

(2) **"Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.**

* * *

(b) **A corporation having income from business activity which is taxable both within and without this State shall allocate and apportion its net income or net loss as provided in this section.**

* * *

(c) **Rents and royalties from real or tangible personal property, gains and losses, interest, dividends less the portion deductible under G.S. 105-130.7, patent and copyright royalties and other kinds of income, to the extent that they constitute nonbusiness income, less**

related expenses shall be allocated as provided in subsections (d) through (h) of this section.

(d)(1) Net rents and royalties from real property located in this State are allocable to this State.

(2) Net rents and royalties from tangible personal property are allocable to this State:

a. If and to the extent that the property is utilized in this State, or

b. In their entirety if the corporation's commercial domicile is in this State and the corporation is not organized under the laws of, or is not taxable in, the state in which the property is utilized.

* * *

(e)(1) Gains and losses from sales or other disposition of real property located in this State are allocable to this State.

(2) Gains and losses from sales or other disposition of tangible personal property are allocable to this State if

a. The property had a situs in this State at the time of the sale, or

b. The corporation's commercial domicile is in this State and the corporation is not taxable in the state in which the property has a situs.

(3) Gains and losses from sales or other disposition of intangible personal property are allocable to this State if the corporation's commercial domicile is in this State.

(f) Interest and net dividends are allocable to this State if the corporation's commercial domicile is in this State subject to the following limitations:

* * *

(g)(1) Royalties or similar income received from the use of patents, copyrights, secret processes and other similar intangible property are allocable to this State:

a. If and to the extent that the patent, copyright, secret process or other similar intangible property is utilized in this State, or

b. If and to the extent that the patent, copyright, secret process or other similar intangible property is utilized in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this State.

(2) A patent, secret process or other similar intangible property is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, processing, or other use in the state or to the extent that a patented product is produced in the state. If the basis of receipts from such intangible property does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the intangible property is utilized in the state in which the taxpayer's commercial domicile is located.

(3) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of

receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

(h) The income less related expenses from any other nonbusiness activities or investments not otherwise specified in this section is allocable to this State if the business situs of the activities or investments are located in this State.

(i) All business income of corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. Provided, that where the sales factor does not exist, the denominator of the fraction shall be the number of existing factors and where the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction shall be the number of existing factors plus one.

(j)(1) The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the income year.

(2) Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight times the net

annual rental rate. Net annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from subrentals except that subrentals shall not be deducted when they constitute business income. Any property under construction and any property the income from which constitutes nonbusiness income shall be excluded in the computation of the property factor.

(3) The average value of property shall be determined by averaging the values at the beginning and end of the income year, but in all cases the Secretary of Revenue may require the averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property. A corporation which ceases its operations in this State before the end of its income year because of its intention to dissolve or to relinquish its certificate of authority, or because of a merger or consolidation, or for any other reason whatsoever shall use the real estate and tangible personal property values as of the first day of the income year and the last day of its operations in this State in determining the average value of property, but the Secretary may require averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property.

(k)(1) The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the income year by the corporation as compensation, and the denominator of which is the total compensation paid everywhere during the income year. All compensation paid to general executive officers and all compensation paid in connection with nonbusiness income shall be excluded in computing the payroll factor. General executive officers shall include the chairman of the board, president, vice-presidents, secretary, treasurer, comptroller, and any other officers serving in similar capacities.

(2) Compensation is paid in this State if:

a. The individual's service is performed entirely within the State; or

b. The individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or

c. Some of the service is performed in this State and (i) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this State, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some

part of the service is performed, but the individual's residence is in this State.

(l)(1) The sales factor is a fraction, the numerator of which is the total sales of the corporation in this State during the income year, and the denominator of which is the total sales of the corporation everywhere during the income year. Notwithstanding any other provision under this Division, the receipts from any casual sale of property shall be excluded from both the numerator and the denominator of the sales factor. Where a corporation is not taxable in another state on its business income but is taxable in another state only because of nonbusiness income, all sales shall be treated as having been made in this State.

(2) Sales of tangible personal property are in this State if the property is received in this State by the purchaser. In the case of delivery of goods by common carrier or by other means of transportation, including transportation by the purchaser, the place at which the goods are ultimately received after all transportation has been completed shall be considered as the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person or firm designated by a purchaser from within or without the State shall constitute delivery to the purchaser in this State.

(3) Other sales are in this State if:

a. The receipts are from real or tangible personal property located in this State; or

b. The receipts are from intangible property and are received from sources within this State; or

c. The receipts are from services and the income-producing activities are in this State.

* * *

N.C. Gen. Stat. § 105-130.7. Deductible portion of dividends.

Dividends from stock issued by any corporation shall be deducted to the extent herein provided.

(1) As soon as may be practicable after September 30 of each year, the Secretary of Revenue shall determine from the corporate income tax return filed during the year ending September 30 by each corporation required to file a return during that period the proportion of the entire net income or loss of the corporation allocable to this State under the provisions of G.S. 105-130.4, except as provided herein. If a corporation has a net income in North Carolina and a net loss from all sources wherever located, or if a corporation has a net loss in North Carolina and a net income from all sources wherever located, the Secretary shall require the use of the allocation fraction determined under the provisions of G.S. 105-130.4. A corporation which is a stockholder in any such

corporation shall be allowed to deduct the same proportion of the dividends received by it from such corporation during its income year ending on or after September 30. * * *

N.C.Gen.Stat. § 105-203. Shares of stock.

All shares of stock (including shares and units of ownership of mutual funds, investment trusts, and investment funds) owned by residents of this State or having a business, commercial, or taxable situs in this State on December 31 of each year, with the exceptions herein provided, shall be subject to an annual tax, which is hereby levied, of twenty-five cents (25¢) on every one hundred dollars ($100.00) of the total fair market value of the stock on December 31 of each year less the proportion of the value that is equal to:

(1) In the case of a taxpayer that is a corporation, the proportion of the dividends upon the stock deductible by the taxpayer in computing its income tax liability under G.S. 105-130.7 without regard to the fifteen thousand dollar ($15,000) limitation under G.S. 105-130.7; and

(2) In the case of a taxpayer that is not a corporation, the proportion of the dividends upon the stock that would be deductible by the taxpayer, if the taxpayer were a corporation, in computing its income tax liability under the provisions of G.S. 105-130.7(1), (2), (3), and (3a), without regard to

the fifteen thousand ($15,000) limitation under G.S. 105-130.7.

* * *

[as written for 1990]

N.C. Gen. Stat. § 105-206. When taxes due and payable; date lien attaches; nonresidents; forms for returns; extensions.

All taxes levied in this Article or schedule shall become due and payable on the fifteenth day of April of each year, and the lien of such taxes shall attach annually to all real estate of the taxpayer within this State as of December 31 next preceding the date that such taxes become due and payable, regardless of the time at which liability for the tax may arise or the exact amount thereof be determined; and said lien shall continue until such taxes, with any interest, penalty and costs which shall accrue thereon, shall have been paid.

Every person, firm, association, corporation, clerk of court, guardian, trustee, executor, administrator, receiver, assignee for creditors, trustee in bankruptcy or other fiduciary owning or holding any intangible personal properties defined and classified and/or liable for or required to pay any tax levied in this Article or schedule, either as principal or agent, shall make and deliver to the Secretary of Revenue in such form as he may prescribe in full, accurate and complete return of such tax liability; such return, together with the total amount of tax due, shall be filed on or before the fifteenth day of April in

each year. In case of sickness, absence or other disability or whenever in his judgment good cause exists, the Secretary of Revenue may allow further time for filing returns.

For the purpose of protecting the revenue of this State and to avoid discrimination and prevent evasion of the tax imposed by this Article, every resident or nonresident person, firm, association, trustee or corporation, foreign or domestic, engaged in this State, either as principal or as agent or representative of or on behalf of another, in buying, selling, collecting, discounting, negotiating or otherwise dealing in or handling any of the intangible property defined in this Article, shall be deemed to be doing business in this State for the purpose of this Article, and the principal, superior or person on whose behalf such business is carried on in this State shall likewise be deemed to be doing business in this State, for the purpose of this Article, and where such business is carried on in this State by a corporation, foreign or domestic, it and its parent corporation or the corporation which substantially owns or controls it, by stock ownership or otherwise, shall be deemed to be doing business in this State for the purpose of this Article, and in all such cases the said intangible property acquired in the conduct of such business in this State, and outstanding on December 31 of each year or on any other taxable date, shall be deemed to have a situs in this State and subject to the tax imposed by this Article, notwithstanding any transfer between any of such parties and notwithstanding that the same may be kept or may then be outside of this State, and any of the intangible property defined in this Article and acquired in the conduct of any business carried on in this State, and/or having a business,

commercial or taxable situs in this State, shall be subject to said tax and returned for taxation by the owner thereof or by the agent, person, or corporation in this State employed by such owner to handle or collect the same. Furthermore, the intangible personal property of the estate of any resident of North Carolina shall be deemed to have a taxable situs in this State, and a nonresident administrator or executor of such an estate shall be subject to the requirements of this Article or schedule in the same manner and to the same extent as a resident administrator or executor.

The Secretary of Revenue shall cause to be prepared blank forms for said returns and shall cause them to be distributed throughout the State, and to be furnished upon application; but failure to receive or secure forms shall not relieve any taxpayer from the obligation of making full and complete return of intangible personal properties as provided in this Article or schedule.

N.C. Gen. Stat. § 105-215. Unconstitutionality or invalidity; interpretation; repeal.

If any clause, sentence paragraph or part of this Article or schedule shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this Article or schedule, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment shall have been rendered. No caption of any section or set of sections

shall in any way affect the interpretation of this Article or any part thereof. All acts and parts of acts inconsistent with the provisions of this Article or schedule are specifically hereby repealed.

N.C. Gen. Stat. § 105-216. Reversion to local units in case of invalidity.

If any clause, sentence, paragraph, or part of this Article or schedule shall for any reason be adjudged by any court of competent jurisdiction to be invalid, and if by virtue of said judgment any one or all of the several taxes classified and levied in this Article or schedule is/are held invalid, then the particular class or classes of intangible personal property affected by said judgment shall become subject to listing, assessment and taxation by the county, municipality, and other taxing jurisdictions in which said intangible personal property has situs in the same manner and at the same rates as applicable to real estate and other tangible properties: Provided, that in such case said listing, assessment and taxation of such intangible personal property by said local taxing units shall become valid and effective as of the tax listing date next preceding March 24, 1939, and shall continue thereafter with full force and effect as if such properties were made taxable by the local taxing unites by direct statutory enactment.

N.C. Gen. Stat. § 105-267. Taxes to be paid; suits for recovery of taxes.

No court of this State shall entertain a suit of any kind brought for the purpose of preventing the collection of any tax imposed in this Subchapter. Whenever a person shall have a valid defense to the enforcement of the collection of a tax assessed or charged against him or his property, such person shall pay such tax to the proper officer, and such payment shall be without prejudice to any defense of rights he may have in the premises. At any time within 30 days after payment, the taxpayer may demand a refund of the tax paid in writing from the Secretary of Revenue and if the same shall not be refunded within 90 days thereafter, may sue the Secretary of Revenue in the courts of the State for the amount so demanded. Such suit may be brought in the Superior Court of Wake County, or in the county in which the taxpayer resides at any time within three years after the expiration of the 90-day period allowed for making the refund. If upon the trial it shall be determined that such a tax or any part thereof was levied or assessed for an illegal or unauthorized purpose, or was for any reason invalid or excessive, judgment shall be rendered therefor, with interest, and the same shall be collected as in other cases. The amount of taxes for which judgment shall be rendered in such action shall be refunded by the State; provided, nothing in this section shall be construed to conflict with or supersede the provisions of G.S. 105-241.2.

1995 N.C. Sess. Laws Ch. 41.

Chapter 41 General Assembly of North Carolina 1995 Session Ratified Bill entitled "An Act to Repeal the Intangibles Tax and to Reimburse Local Governments for their Resulting Revenue Loss," ratified April 18, 1995.

The General Assembly of North Carolina enacts:

Section 1.

***

(b) Effective January 1, 1995, the remainder of Article 7 [the Intangibles Tax Article] of Chapter 105 of the General Statutes is repealed.

***

- END -

(5)

No. 94-1239

In the Supreme Court of the United States

OCTOBER TERM, 1994

FULTON CORP., *Petitioner*

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,
Respondent

On Writ of Certiorari to the Supreme Court of North Carolina

MOTION TO DISMISS THE WRIT OF CERTIORARI AS IMPROVIDENTLY GRANTED

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MOTION TO DISMISS THE WRIT OF CERTIORARI AS IMPROVIDENTLY GRANTED

Pursuant to Rule 21 of the Rules of this Court, respondent respectfully suggests that developments since the grant of certiorari in this case make it appropriate for the Court to dismiss the writ of certiorari as improvidently granted.

1. This case involves a Commerce Clause challenge to North Carolina's tax on intangible property. Insofar as is relevant here, the tax was imposed on shares of stock owned by North Carolina residents. Under the so-called "taxable percentage deduction" provision of the statute, residents were permitted in calculating their tax liability to deduct a

percentage of the shares' value equal to the percentage of the issuing corporation's income that was subject to tax in North Carolina. N.C. Gen. Stat. § 105-203. Thus, for example, because 100% of the income of a corporation engaged in business exclusively in North Carolina would be subject to the State's income tax, a shareholder of that corporation could deduct 100% of the value of the shares (leaving no property tax liability). Conversely, the shares of a corporation that did no business in North Carolina and consequently was not subject to the State's income tax would be taxed to the shareholder at 100% of their value.

The petitioner in this case, a North Carolina corporation that itself owned stock in other corporations, brought an action in state court challenging the North Carolina intangibles tax as inconsistent with the Commerce Clause of the United States Constitution. The tax was upheld by the trial court. The North Carolina Court of Appeals reversed, holding the taxable percentage deduction unconstitutional. That court denied petitioner refund relief, however, holding as a matter of state law that the taxable percentage deduction was severable from the remainder of the tax provision. Pet. App. 18a-35a. The North Carolina Supreme Court then reversed in turn, holding the taxable percentage deduction constitutional under *Darnell* v. *Indiana*, 226 U.S. 390 (1912). Pet. App. 1a-17a. The state supreme court accordingly did not reach the question of remedy. This Court granted the petition for a writ of certiorari on April 17, 1995, to address the question whether the taxable percentage deduction violates the United States Constitution. See Pet. i.

2. Respondent submits this motion because, after the grant of certiorari, the State of North Carolina repealed the tax on corporate shares that is at issue in this case. 1995

N.C. Sess. Laws ch. 41.[1] As a consequence, the question on which the Court granted review is of no continuing importance in North Carolina. Nor is it of general significance to the Nation. The trend has been towards repeal of provisions like North Carolina's taxable percentage deduction (in addition to North Carolina, Indiana recently repealed its tax, see Ind. Pub. L. No. 80-1989, 1989 Ind. Acts 912, 919). So far as we are aware, only two States (Kentucky and Pennsylvania) currently have such provisions, and a challenge to the Kentucky tax is now pending in that State's supreme court. *St. Ledger* v. *Commonwealth of Kentucky*, No. 92-CA-2688-MR (Ky. App. May 20, 1994), mot. for rev. granted, No. 94-SC-468-D (Ky. Oct. 19, 1994).

The repeal of the statutory section at issue therefore eliminates the "special and important reasons" for which this Court's certiorari jurisdiction was invoked. See this Court's Rule 10. In such circumstances, the Court often has dismissed the writ as improvidently granted. See, *e.g.*, *Cook* v. *Hudson*, 429 U.S. 165 (1976) (per curiam) (writ dismissed, in part, because newly enacted statute prevented issue from arising again); *Morris* v. *Weinberger*, 410 U.S. 422 (1973) (per curiam) (writ dismissed where Congress amended challenged portion of Social Security Act twenty days after writ granted); *Triangle Improvement Council* v.

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[1] Although the repeal coincidentally was effected on April 18, 1995, the day after certiorari was granted, it plainly was not motivated by this Court's decision to review this case. The bill to repeal the intangibles tax was introduced in the North Carolina Senate on January 26, 1995 (see N.C. Sen. Bill 8), was reported favorably by committees of the North Carolina Senate and House on February 7, 1995, and March 8, 1995, respectively, and was approved by the respective Houses of the Legislature on February 9, 1995, and April 17, 1995. There accordingly can be no doubt that the taxable percentage deduction would have been repealed regardless of the Court's decision to grant review.

Ritchie, 402 U.S. 497 (1971) (per curiam) (writ dismissed where Congress repealed Act on which petitioner based challenge to highway project); *Sanks* v. *Georgia*, 401 U.S. 144 (1971) (writ dismissed where challenged portions of statute were amended); *Rice* v. *Sioux City Memorial Park Cemetery, Inc.*, 349 U.S. 70 (1955) (writ dismissed where newly enacted statute prevented case from arising again).

3. Although repeal of the challenged tax does not render this case moot because petitioner is seeking refund relief, that should not preclude dismissal of the writ. In similar circumstances, the Court has noted that "it is very important that we be consistent in not granting the writ of certiorari except in cases involving *principles* the settlement of which is of importance to the public, as distinguished from that of the parties * * *." *Rice*, 349 U.S. at 79 (citation and internal quotation marks omitted) (emphasis added). The Court has emphasized that "[t]his is especially true where the issues involved reach constitutional dimensions, for then there comes into play regard for the Court's duty to avoid decision of constitutional issues unless such avoidance becomes evasion." *Id.* at 74. See also *Triangle Improvement Council*, 402 U.S. at 499 (Harlan, J. concerning) ("the exercise of our powers of review would be of no significant continuing national import"); *Sanks*, 401 U.S. at 151 (dismissing writ even though subsequent change in statute might not protect petitioner; "it has always been a matter of fundamental principle with this Court, a principle dictated by our very institutional nature and constitutional obligations, that we exercise our powers of judicial review only as a matter of necessity").

That principle applies with particular force in this case because petitioner and other similarly situated North Carolina taxpayers most likely would *not* obtain a refund even if petitioner were to prevail on the merits of its Commerce Clause challenge in this Court. Petitioner itself acknowledged in its petition for certiorari (at 3 n.1) that it "does not here

seek review of the federal issues raised by the adverse decision of the North Carolina Court of Appeals on its refund demand"; petitioner also "under[stood] that those issues can be reconsidered by the North Carolina courts in the event that this Court reverses and remands the North Carolina Supreme Court's decision." And given the state court of appeals' conclusion as a matter of state law that the taxable percentage deduction should be severed from the remainder of the tax code, it surely is probable that petitioner would not ultimately obtain refund relief on remand to the state courts.[2]

4. In sum, this case now presents an essentially hypothetical question that is of no continuing importance in North Carolina and is of very little significance elsewhere. Resolution of that question will not settle even the entitlement of the petitioner in this case to a refund remedy. In these

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[2] Under *McKesson Corp.* v. *Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 39-41 (1990), a State may remedy a tax that discriminates against interstate commerce by retroactively raising the taxes of in-state beneficiaries of that discrimination. While the North Carolina Constitution generally precludes retroactive taxation (see N.C. Const. art. I, § 16), that rule may not apply where a tax increase remedies a federal constitutional violation. Yet such a retroactive tax increase would be of no benefit to petitioner, which (in contrast to the taxpayer in *McKesson*, see *id.* at 42-43), is not a competitor of North Carolina residents who own the shares of in-state corporations and whose taxes would be increased by such a remedy. As a result, there is reason to doubt that petitioner would obtain any benefit from a victory on the merits in this case. We also note that petitioner's demand for a refund essentially seeks a windfall. The real "victims" of the assertedly unconstitutional discrimination in this case are the out-of-state corporations whose sale of stock in North Carolina purportedly was burdened by the taxable percentage deduction. A refund here, however, would go not to those corporations but to petitioner, a North Carolina resident. Such a refund would not advance any Commerce Clause value.

circumstances, it would be appropriate for the Court to dismiss the writ of certiorari as improvidently granted.

Respectfully submitted.

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JUNE 13, 1995

(6)

No. 94-1239

IN THE SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,

Respondent.

On Writ of Certiorari to the
Supreme Court of North Carolina

PETITIONER'S RESPONSE TO RESPONDENT'S MOTION TO DISMISS THE WRIT

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PETITIONER'S RESPONSE TO RESPONDENT'S MOTION TO DISMISS THE WRIT

STATEMENT OF FACTS

This action involves a state statute that taxes shareholders on the value of their stock more lightly when the corporation pays income tax to North Carolina on a higher percentage of its income (because a higher percentage of its payroll, property and sales is in the

state). Fulton Corporation[1] contends that this regime facially discriminates against interstate commerce. The Secretary contends that the income tax paid by the local corporations is a "compensating tax" that justifies the facial discrimination, that it is appropriate to protect local folk from "double taxation" in this manner, and that *Darnell v. Indiana*, 226 U.S. 390 (1912) is controlling and permits such a regime. The issues presented in the Brief for the Petitioner include:

> whether *Darnell* is factually controlling or has continuing validity;
>
> whether *Darnell* and the North Carolina taxing scheme involve a successful compensating tax defense, in view of the fact that in neither case is there an intrastate burden for which the heavier tax on foreign corporations' stock compensated;
>
> whether the compensating tax defense applies here by its terms;
>
> whether a compensating tax defense can be successful when the tax fails the internal consistency test applied in Commerce Clause cases;
>
> whether taxes on shareholders and on their corporation can be aggregated in making the internal consistency analysis.

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[1] Rule 29.1 Statement: Petitioner Fulton Corporation states that it has neither a corporate parent nor a corporate subsidiary.

Fulton filed this action over four years ago. Under the North Carolina tax statutes it had no pre-deprivation remedy by which to contest the constitutionality of the intangibles tax and was forced to pay the tax and sue for refund. It had to carefully make its claim for refund within the short period of 30 days after paying the tax, as required by North Carolina for refund claims based on illegality of the tax. N.C.Gen.Stat. §105-267; Pet. Brief App. 14a. Fulton lost in the trial court and won an interim victory, after two years of litigation, in the Court of Appeals. A year and a half later, the North Carolina Supreme Court reversed. As the litigation proceeded throughout 1992, 1993 and 1994, Fulton continued to pay the tax, which discriminates against interstate commerce; so did tens of thousands of other North Carolina taxpayers in amounts totaling more than $50,000,000 yearly.

The North Carolina General Assembly was considering repeal of the intangibles tax while Fulton's petition for writ of certiorari was pending before this Court. That repeal occurred shortly after the Court issued its writ.

Fulton brought to the Court's attention in its brief on the merits served on May 30, 1995 that the intangibles tax statute at issue was repealed after this Court granted its writ. In section E of the Statement of Facts (p. 8 of the Brief for the Petitioner), Fulton further informed the Court of the following points:[2]

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[2] For the Court's convenience, that section of the brief for the Petitioner is reproduced in the Appendix hereto.

1. The repeal will first apply to returns that would be due in 1996. [That is, North Carolina collected and retains the intangibles taxes due for 1994 on April 15, 1995, three days before the repeal, and continues to enforce the intangibles tax by audit and assessment for prior open years.]

2. The repeal does not affect the tax year at issue in this action, 1991.

3. The repeal does not address or satisfy Fulton's claim in this action, which is for a refund of tax paid for 1991, or Fulton's refund claims for later years, or the refund claims of thousands of similarly situated North Carolina taxpayers for 1992, and particularly 1993 and 1994 intangibles taxes on stock. [Taxes for these two years became due after the decision of the North Carolina Court of Appeals in this action alerted taxpayers generally that the tax is unconstitutional. Many tax return preparers in the state regularly undertook to assist their clients by submitting timely refund claims for intangibles taxes paid thereafter in 1994 and 1995.]

4. The case is not moot, nor is the importance of the legal issues upon which this Court issued its writ of certiorari diminished.

The Secretary of Revenue on June 13, after filing of Brief for the Petitioner, moved to dismiss the writ as improvidently granted, agreeing that the case is not moot.

ARGUMENT

A. This Court Cannot Allow States to Follow a Pattern or Practice of Collecting Unconstitutional Taxes, and When Review by This Court Seems Imminent, To Repeal the Taxes Prospectively, and Keep All Taxes Collected by Avoiding Review by This Court.

The Secretary's motion at fn. 1 asserts that the Court's grant of the writ did not motivate the repeal. This acknowledges an understanding that this Court would look unfavorably on an effort to maximize illegal taxation by waiting until the last minute to repeal the illegal tax, thereby collecting it as long as possible, and avoid this Court's review.

The sequence of events in this case and particularly the timing of the repeal strongly suggest that it was the spectre of this Court's intervention and of possible resulting substantial tax refunds that contributed to the legislation.

Although this Court on rare occasions, and normally on its own motion, has dismissed its writ as improvidently granted when, among other facts, the statute in question was repealed, such dismissal is particularly inappropriate for this case.

This case is one of a large group recently before this Court that involve efforts by states to retain the proceeds of an unconstitutional tax. The Court should adhere to its strong line of decisions holding firm on the duty of states to provide adequate remedies for illegal

taxes and not to play games with taxpayers' rights under the United States Constitution.

The Court has repeatedly rejected state ploys to retain the fruits of unconstitutional taxes. First, Florida claimed that it had no obligation at all to rectify an unconstitutional tax. But in *McKesson v. Div. of Alcoholic Beverages*, 496 U.S. 18 (1990) the Court ruled that states that do not provide a pre-deprivation remedy must provide a meaningful, clear and certain, post-deprivation remedy for unconstitutionally collected taxes, either by refund to disfavored taxpayers or by assessment of favored taxpayers to produce equality in taxation.

Next, Virginia argued that it could give purely prospective relief. In *Harper v. Virginia Dept. of Taxation*, 113 S. Ct. 2510 (1993) the Court ruled that once it applies a determination of unconstitutionality to one state taxpayer its determination should be applied retroactively to all other similarly situated taxpayers, who should receive meaningful backward-looking relief.

Finally, Georgia sought to make the remedial path more difficult after this Court found its tax to be unconstitutional. In *Reich v. Collins*, 115 S. Ct. 547 (1994) (involving a short statute of limitations akin to that in N.C.Gen. Stat. §105-267) the Court ruled that a state cannot "bait and switch" remedies for unconstitutional taxes.

These and other decisions of this Court in recent years illustrate that states frequently attempt to protect their treasuries from the loss of unconstitutionally

collected taxes and that this Court has consistently headed off such attempts. By repealing the statute and moving to dismiss the writ North Carolina presents an innovative method of attempting to retain unconstitutionally collected taxes. If the Court grants this motion, this case will provide a roadmap allowing states to be relatively unconcerned about the constitutionality of their taxes, as they will know that they can repeal them prospectively when review by this Court appears possible, and pay no refunds.

The State of North Carolina has a particularly questionable record in regard to retaining illegally collected taxes. As noted above, it already has the extremely short thirty day statute of limitations for refund claims based on illegality of the tax, and as noted below it does not allow class claims for refunds, thus placing substantial practical and financial hurdles in the way of taxpayers who would contest the constitutionality of taxes that are not large for any one taxpayer. Its record of avoiding refunds of taxes illegally collected from federal retirees is an impressive example of the difficulties faced by North Carolina taxpayers who contest unconstitutional North Carolina taxes.

This Court ruled unconstitutional a state's taxation of pensions of federal retirees while exempting the pensions of its own retirees in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989) on March 29, 1989. In response, North Carolina collected the illegal tax due on April 15, 1989, prospectively repealed its discriminatory scheme for taxing federal retirees, and enacted an ineffective future tax credit for 1988 taxes

paid by federal retirees. It paid refunds of only about $9 million to only about 12,000 of more than 90,000 federal retirees (who paid over $40 million in taxes for 1988), who managed to submit refund claims within 30 days after paying their 1988 taxes in the spring of 1989. Brief in Opposition to Petition for Writ of Certiorari in *Swanson v. State*, USSC No. 93-1882, p. 6; Appendix to Petition for Writ of Certiorari in No. 93-1882, pp. A-169 and 173. North Carolina paid no refunds for earlier years and did not honor a class refund claim for 1988 taxes, under a decision of the North Carolina Supreme Court refusing to permit such a class refund claim. *Swanson v. State*, 335 N.C. 674, cert. denied, 115 S. Ct. 662 (1994). Furthermore, of the 23 states with discriminatory schemes similar to the one in the *Davis* case, North Carolina was possibly the only one that did not provide a judicial or suit settlement remedy to the class of federal retirees.

Having escaped relatively unscathed from the *Davis* case illegality, North Carolina has been emboldened to try once again to avoid refund of illegal taxes. The Court should not countenance the state's latest effort to sidestep the consequences of collecting an impermissibly discriminatory tax.

B. The Case Retains the Same Issues of Importance for which This Court Granted Its Writ.

The motion incorrectly states that "the question on which the Court granted review is of no continuing importance in North Carolina." It is of importance to Fulton's refund claims for the year at issue in this action

and later years and to the similar claims made individually by thousands of other North Carolina taxpayers under advice of tax professionals in the state. After the June 15, 1993 decision of the Court of Appeals most tax return preparers in North Carolina knew that recovery of intangibles taxes on stocks was a possibility and many major preparers routinely made demand for refund of intangibles taxes on stocks within the statutorily allotted time period in 1994 and 1995.

Furthermore, the broader significance of this action is not limited to states with intangibles taxes. It affects every taxing regime that employs a scheme to prevent alleged "double taxation" of local business by providing a tax benefit to local business and thus discriminating against out of state business. It affects every state court that might rely on *Darnell v. Indiana*, 226 U.S. 390 (1912) as authority for such discrimination under a compensating tax theory. It affects every state court that might rely on the North Carolina Supreme Court decision to ignore this Court's internal consistency test when a compensating tax is (incorrectly) found.

The authorities cited by the Secretary are not compelling. One involved a statutory amendment that retroactively gave the petitioner the right sought. *Morris v. Weinberger*, 410 U.S. 422 (1973). One involved multiple grounds for dismissal aside from repeal of the statute. *Triangle Improvement Council v. Ritchie*, 402 U.S. 497 (1971). One involved plaintiffs who no longer needed the relief sought, thus rendering the case clearly moot; because the petitioners might need other relief in the future, the Court did not rest its *remand* on

mootness, but found that it should not retain the case as it was not then known that such relief would be needed. *Sanks v. Georgia*, 401 U.S. 144 (1971). Fulton Corp. in its Brief for the Petitioner at fn. 2 also cited a fourth case cited by the Secretary, *Rice v. Sioux City Memorial Park Cemetery*, 349 U.S. 70 (1955), pointing out that the statutory change there prevented any future plaintiff from encountering the problem encountered by the petitioner. That is not true here as current and future North Carolina plaintiffs (and Fulton Corp. in a refund action for taxes paid in other years) seeking refund of intangibles taxes paid for 1992, 1993 and 1994 will encounter as a bar the North Carolina Supreme Court decision at issue here, unless this Court acts. The Court granted its writ in *Cook v. Hudson*, 429 U.S. 165 (1976), the last case cited by the motion, in part to review the propriety of segregated private schools, which was resolved in *Runyon v. McCrary* in the interim, in contrast to the unresolved issues here.

C. Fulton and Others Will Be Entitled to Refunds.

The Secretary's motion erroneously states "petitioner and other similarly situated North Carolina taxpayers most likely would not obtain a refund even if petitioner were to prevail on the merits . . . ." This implies that the case is not of importance because no useful remedy can be forthcoming, as in *Sanks*. This is not correct. Fulton and thousands of other taxpayers will be entitled to refunds.

This Court's reversal of the Supreme Court of North Carolina will mean that Fulton paid an

unconstitutional tax and will be entitled to meaningful backward-looking relief under *Harper*, 113 S. Ct. 2510. That relief may be either refund or equality of treatment produced by requiring all taxpayers who used the discriminatory deduction for 1991 (and 1992, 1993 and 1994) to pay additional taxes resulting from loss of the deduction. The only practical way, however, to remove the discrimination under the intangibles tax on stocks will be to refund the tax.

The Secretary's argument is akin to that made by the state in *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989). In that case, the taxpayer sued for refund of tax paid for a three years period during which required it to pay sales and use tax on its magazine, but did not tax religious magazines. The taxpayer sought no prospective relief because the statute had been changed to relieve it of the tax. The state argued that the taxpayer lacked standing because no prospective remedy was needed and no refund would be allowed because the proper remedy would be to remove the exemption of religious magazines. The Court found this contention misguided as one that would "effectively insulate underinclusive statutes from constitutional challenge, ... " 489 U.S. at 8. Similarly, through its motion North Carolina would effectively insulate repealed statutes from constitutional review by this Court.

In *Texas Monthly*, in words directly applicable to the instant case, the Court said:

> It is not for us to decide whether the correct response as a matter of state law to a finding that a state tax exemption is unconstitutional is to

eliminate the exemption, to curtail it, to broaden it, or to invalidate the tax altogether. Nor does it make any difference - contrary to the State's suggestion - that Monthly seeks only a refund and not prospective relief, as did the appellant in *Arkansas Writers' Project*. A live controversy persists over Monthly's right to recover the $149,107.74 paid, plus interest. *cannot strip appellant of standing by changing the law after taking its money.* (emphasis added)

489 U.S. at 8.

CONCLUSION

A live controversy exists over whether Fulton (as well as thousands of similarly situated North Carolina taxpayers) can recover its taxes. North Carolina cannot strip Fulton of that possibility by changing the law after taking Fulton's money. The Court should deny the motion to dismiss the writ.

Respectfully submitted,
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APPENDIX

(From Statement of Facts in Brief for the Petitioner)

E. Subsequent Event. Subsequent to this Court's grant of its writ of certiorari, the North Carolina General Assembly repealed the intangibles tax for returns due in 1996. 1995 N.C. Sess. Laws Ch. 41; App. 15a. This repeal does not affect the tax year at issue in this case or Taxpayer's refund claim, which remain unsatisfied (as do the refund claims of the Taxpayer for other years for which a separate suit has been brought, and the refund claims of thousands of similarly situated North Carolina taxpayers for 1991, 1992, 1993 and 1994 taxes). Taxpayer made its refund claim under N.C. Gen. Stat. § 105-267, the only avenue allowed by the North Carolina courts for a taxpayer to contest an illegal tax. App. 14a. Therefore, the case is neither moot nor is the importance of the legal issues upon which this Court issued its writ of certiorari diminished.[3]

3

The case is not moot so long as the parties have a concrete interest in the outcome of the action, however small. *See University of v. Camenisch*, 451 U.S. 390 (1981); *Powell v. McCormack*, 395 U.S. 486, 495-500 (1969); *Ellis v. Brotherhood of Clerks*, 466 U.S. 435 (1984) (not moot where claim for damages remained); *Board of Pardons v. Allen*, 482 U.S. 369, 370 n. 1 (1987) (remaining claims for damages prevented mootness). Furthermore, the significance of the issue on which this Court granted its writ continues. The instant case is distinguishable from perhaps the classic case in which this Court discussed dismissal of a previously granted writ, wherein the state adopted a statute that precluded any future enforcement of the offensive cemetery contract terms at issue in the case, so that

similarly situated plaintiffs in any other case arising in the future would be entitled to damages. *Rice v. Sioux City Memorial Park Cemetery*, 349 U.S. 70 (1955). Here Fulton Corp. and other North Carolina taxpayers have pursued and can pursue refund of these illegal taxes and have been and will be denied those refunds on the basis of the decision of the Supreme Court of North Carolina in the instant case.

QUESTION PRESENTED

Whether the taxable percentage deduction of North Carolina's former intangibles tax is consistent with the Commerce Clause of the United States Constitution.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

FULTON CORP., *Petitioner*

v.

JANICE H. FAULKNER, *Respondent.*

On Writ of Certiorari to the Supreme Court of North Carolina

BRIEF OF RESPONDENT

STATEMENT

1. This case involves the interaction of two North Carolina taxes, one on corporate income and the other the State's since-repealed tax on intangible property, which includes corporate stock. Under the income tax, firms that conduct business entirely in North Carolina pay a tax on 100% of their income; firms that conduct only a portion of their business in North Carolina are taxed on the percentage of their income that is properly attributable to activities in the State. That percentage is determined by application of a conventional apportionment formula. First, the amounts of the firm's payroll, property and sales in North Carolina are

respectively divided by the firm's *total* payroll, property and sales. Those percentages, with the sales factor double-weighted, are themselves then averaged. The resulting figure is the percentage of the firm's total income that is taxable in North Carolina. N.C. Gen. Stat. § 105-130.4(i)-(l). See Pet. App. 3a-4a.[1] Once the tax base is determined, the income tax is applied at a rate of 7.75%. N.C. Gen. Stat. § 105-130.3.

During the period relevant here, the intangibles tax was imposed on the fair market value of specified intangibles, including shares of stock, that were owned by North Carolina residents. Under the so-called "taxable percentage deduction" provision of the tax statute, residents were permitted in calculating their intangibles tax liability to deduct a percentage of their shares' value equal to the percentage of the issuing corporation's income that was subject to tax in North Carolina, as determined through use of the corporate income tax apportionment formula. N.C. Gen. Stat. § 105-203.[2] Thus, for example, because 100% of the income of a corporation engaged in business exclusively in North Carolina

[1] In addition, certain nonbusiness investment income of corporations domiciled in North Carolina is allocated in its entirety to North Carolina for income tax purposes. N.C. Gen. Stat. § 105-130.4(c)-(g). See generally *Allied-Signal, Inc.* v. *Director*, 112 S. Ct. 2251, 2262 (1992).

[2] North Carolina uses the same taxable percentage system in determining the portion of stock dividends subject to tax. N.C. Gen. Stat. § 105-130.7. In fact, the taxable percentage deduction available under the intangibles tax actually incorporates by reference the percentage limitation on the dividends tax. See N.C. Gen. Stat. § 105-203(1), (2). Nonbusiness income of North Carolina domiciliaries that is allocated to the State for income tax purposes also is taken into account in determining the portion of share value subject to the intangibles tax. N.C. Gen. Stat. § 105-130.5.

would be subject to the State's income tax, a shareholder of that corporation could deduct 100% of the value of the shares (leaving no property tax liability). Conversely, shares of a corporation that did no business in North Carolina and consequently was not subject to the State's income tax would be taxed to the shareholder at 100% of their value. Shares of a corporation that did a portion of its business in North Carolina (say, 60%) would be deductible to that extent (meaning, in this example, that the shares would be taxable at 40% of their value). See Pet. App. 5a-6a. During the relevant period the tax was imposed at the rate of 25 cents per $100 worth of stock.

As we explain in more detail below (at 21-23), the taxable percentage deduction was designed to avoid what was thought to be duplicative taxation of a single corporate value. In its initial form, the intangibles tax exempted all corporate shares, but was imposed on other intangibles at an unusually high rate. In 1928, the State Tax Commission accordingly proposed a revision of the tax. The Commission explained that

> [s]hares of stock of domestic corporations are now exempt from taxation on the ground that the real and personal property of the corporation has paid its tax, presumably within the state, and that to tax the shares separately would be objectionable double taxation. Also on the ground that in so far as the corporation has high earning power with little or no tangible property, we are reaching it through our corporate excess tax.

State of North Carolina, Report of the Tax Commission to Gov. Angus Wilton McLean, at 356 (hereinafter cited as "1928 Report").[3] The Commission therefore proposed extending the intangibles tax to corporate shares, while

[3] For the Court's convenience, a copy of the relevant portion of the 1928 Report has been lodged with the Clerk of the Court.

avoiding duplicative taxation by exempting shares from the tax to the extent that the issuing corporation paid property or income tax to the State. *Id.* at 356-357. The Commission's recommendation was implemented in 1937, and the tax was put in something much like its current form in 1939. 1939 N.C. Sess. Laws c. 158 s. 705.

2. Petitioner is a North Carolina corporation that itself held stock in other corporations. In 1990, the tax year at issue here, petitioner owned shares of six corporations. Five of the six did no business or earned no income in North Carolina, and therefore were not subject to the State's income tax; petitioners' shares of those corporations were taxed at 100% of their market value. The sixth corporation, Food Lion, Inc., conducted 46% of its business in the State, meaning that 46% of its net income was subject to North Carolina's income tax and 54% of the value of its shares was subject to the intangibles tax. Pet. App. 21a.

In 1991, petitioner paid its intangibles tax for the 1990 tax year, which totaled some $10,884, and then commenced this suit in state court for a refund, contending that the taxable percentage deduction discriminated against out-of-state firms and therefore was inconsistent with the Commerce Clause. The trial court ruled for the State. The North Carolina Court of Appeals reversed, holding the taxable percentage deduction unconstitutional. Pet. App. 18a-35a. That court nevertheless denied refund relief, however, holding as a matter of state law that the proper remedy for the constitutional violation was excision of the taxable percentage deduction from the tax statute, rather than invalidation of the intangibles tax as a whole. *Id.* at 32a-33a. The court added that retroactive application of the statute as revised would be inequitable. *Id.* at 33a.

A unanimous North Carolina Supreme Court then reversed in turn, holding the taxable percentage deduction constitutional. Pet. App. 1a-17a. The court began by

surveying decisions of this Court describing the compensatory tax doctrine (see *id.* at 7a), and then found this case controlled by *Darnell* v. *Indiana*, 226 U.S. 390 (1912). The state court explained that

> [i]n *Darnell* the Supreme Court found substantial equality, sufficient to satisfy the Commerce Clause, in taxing the stock of foreign corporations not paying property taxes and taxing the property of domestic corporations. In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of "compensating" tax scheme the Supreme Court upheld in *Darnell.*

Pet. App. 10a-11a (footnote omitted).

The court rejected the argument that *Darnell* could be distinguished because that case had involved offsetting property taxes (one on tangible corporate property and one on shares) while the North Carolina system presented offsetting income and shares taxes. The court reasoned that it is "a sound generalization that corporate income, and income tax paid, are strongly related to the value of the corporation's stock." Pet. App. 12a. Indeed, the court found as a practical matter that, under the North Carolina regime, "most out-of-state corporations will in fact be paying less taxes to North Carolina, directly in the form of an income tax and indirectly in the form of an intangibles tax against shares, than a similar North Carolina corporation." *Id.* at 14a.

Finally, the court concluded that *Darnell* was consistent with more recent of this Court's decisions. *Id.* at 14a-17a.

3. Shortly after the decision below was issued, a bill to repeal the intangibles tax was introduced in the North Carolina Senate. N.C. Sen. Bill 8 (Jan. 26, 1995). The bill was reported favorably by committees of the North Carolina Senate and House on February 7, 1995, and March 8, 1995, respectively, and was approved by the respective Houses of the legislature on February 9, 1995, and April 17, 1995. The repeal became law on April 18, 1995. 1995 N.C. Sess. Laws ch. 41. The repeal does not have retroactive effect, however, and therefore does not affect the tax liability at issue in this case.

SUMMARY OF ARGUMENT

A. This case is controlled by *Darnell* v. *Indiana*, 226 U.S. 390 (1912). *Darnell* involved a Commerce Clause challenge to a tax that was in all essential respects identical to the one at issue in this case, and the Court in *Darnell* rejected arguments indistinguishable from those advanced here by petitioner. Indiana taxed the shares of foreign corporations, but exempted the shares issued by domestic corporations that themselves paid property tax to the State. The Court upheld this regime because it found that taxing "the property of domestic corporations and the stock of foreign corporations in similar cases" was "consistent with substantial equality notwithstanding the technical differences." *Id.* at 398. Petitioner's attempt to distinguish *Darnell* from this case on the theory that both of the taxes there fell on types of property (tangible property on the one hand and shares on the other) is unpersuasive; in fact, there can be no doubt that a tax on corporate income is a *better* proxy for one on corporate shares than is the tax on tangible corporate property upheld in *Darnell*.

B. This conclusion plainly comports with the compensatory tax doctrine as it has been articulated in the

Court's more recent decisions. *First*, North Carolina's corporate income tax qualifies as a levy on intrastate commerce for which the State properly may compensate. In arguing to the contrary, petitioner contends that the State lacks the power to impose a tax that compensates for the levy on corporate income because North Carolina could not directly tax the income of out-of-state firms that conduct no business in the State. But this contention rests on a fundamental misunderstanding of the compensatory tax doctrine: the very *point* of the doctrine is to permit States to tax values indirectly that they lack the power to reach directly. Here, firms that do business in North Carolina pay through the corporate income tax for that privilege, in the process supporting the functioning of the State's capital market; firms that are not subject to the income tax but that sell their shares to North Carolina residents pay their fair share of the costs of maintaining that capital market indirectly through the intangibles tax. This conclusion is confirmed by the history of the taxable percentage deduction, which establishes beyond peradventure that the income and intangibles taxes were regarded as duplicative of one another.

Second, the income and intangibles taxes are substantially equivalent. To comport with the requirements of the compensatory tax doctrine, the amount of the tax on interstate commerce "must be shown roughly to approximate" that on intrastate commerce. *Oregon Waste Systems, Inc.* v. *Department of Environmental Quality*, 114 S. Ct. 1345, 1352 (1994). Here, given the low rate of the intangibles tax, a firm would have to have an unusually high price-to-earnings ratio for the tax liability of its shareholders to exceed the income tax liability of a comparable corporation that confines its business to North Carolina. Indeed, there is little doubt — and petitioner does not deny — that the dollar burden imposed on interstate businesses through the shares tax will be considerably *lower*, in the vast run of cases, than that imposed on comparable intrastate firms by the income tax.

Third, the interstate and intrastate taxes fall on substantially equivalent events. While petitioner complains that the taxes are imposed on different activities and categories of taxpayers, that is the essential nature of a compensatory tax; compensating sales and use taxes, which fall on different events (sale rather than use of merchandise) and are paid by distinct classes of taxpayers (sellers rather than ultimate consumers of goods) are the paradigmatic example. Here, as a matter of economic reality there is a necessary, close, and manifest relationship between the value of corporate shares and the amount of corporate income. And in contrast to cases where the Court has found the compensatory tax doctrine inapplicable, the income and intangibles taxes in this case serve as mutually exclusive proxies for one another: firms that pay the state income tax do not pay the levy on intangibles, while firms whose shares are subject to the intangibles tax do not pay the income tax.

C. The taxable percentage deduction should not be invalidated under the "internal consistency test," which never has been applied to strike down a state tax like the one at issue here. While the test is used to determine whether a State is taxing more than its fair share of an interstate transaction, North Carolina here is trying to make out-of-state firms shoulder *their* fair share of the taxes used to support the capital market in which they participate. Moreover, even if the internal consistency principle would invalidate other sorts of complementary taxes, it should not be applied to invalidate a tax on intangible property, which historically has been thought unapportionable — and therefore subject to apparently duplicative taxation — because it has no identifiable location and draws distinct benefits from more than one State.

In nevertheless contending that the State must either forgo any tax on intangibles or apply the intangibles tax on precisely equivalent terms to the shares of in-state and out-of-state corporations, petitioner would place the State in an insurmountable bind. Petitioner's first approach would allow

out-of-state firms to escape making any contribution to the maintenance of the North Carolina capital market; the second would subject intrastate commerce to duplicative taxation. After all, we are here proceeding on the hypothesis that the income and intangibles taxes satisfy the requirements of the compensatory tax doctrine — which means that the taxable percentage deduction furthers a legitimate local purpose (that of avoiding duplicative taxation of in-state firms) that cannot be achieved by nondiscriminatory means. Requiring the State to disregard that purpose would contravene the basic understanding that the Commerce Cause was not designed to place interstate commerce in a privileged position.

ARGUMENT

Before turning to the legal arguments offered by petitioner, it is worth pausing to consider several elements of the North Carolina system of taxation that petitioner disregards. *First*, although petitioner treats the discriminatory nature of the taxable percentage deduction as self-evident (see Pet. Br. 15-16), North Carolina's tax regime actually differs in significant respects from those that have been held invalid under the Commerce Clause. The State does not distinguish between corporations or their products on the basis of domicile. Instead, the taxability of corporate shares is determined by the formula used to apportion corporate income, which in turn looks to the percentage of the corporation's payroll, property, and sales present in North Carolina (with the latter factor double-weighted). At least as to the sales factor, this approach is the *mirror-image* of a tariff, which is "the paradigmatic Commerce Clause violation" (*West Lynn Creamery, Inc.* v. *Healy*, 114 S. Ct. 2205, 2217 (1994)): the tax scheme encourages out-of-state firms to sell their goods in North Carolina, in competition with firms domiciled in the State. That is hardly the "economic protectionism" at which the Clause is aimed. *Associated Industries of Missouri* v. *Lohman*, 114 S. Ct. 1815, 1820 (1994).

Second, as a practical matter it is doubtful that the taxable percentage deduction has any actual effect at all on interstate commerce. The "large national corporations" whose shares are 100% (or almost 100%) taxable by North Carolina (see Pet. Br. 5) plainly do not compete for capital with the "incorporated purely local businesses such as corner drugstores, professional associations and the like" (Pet. Br. 4), whose shares are exempt from taxation. Cf. *Alaska* v. *Arctic Maid*, 366 U.S. 199, 204 (1961) (looking to taxes imposed on competitors to gauge Commerce Clause violation). The intangibles tax, moreover, is imposed at the exceedingly low rate of 25 cents per $100 of share value. It therefore is no surprise that interstate corporations *never* have expressed concern to the State about the effect of the taxable percentage deduction either on their operations or on their ability to attract capital. See J.A. 15-20.

Having said that, we nevertheless accept for purposes of the following argument that the taxable percentage deduction, viewed in isolation, does discriminate against interstate commerce. Even on that assumption, however, North Carolina's system of taxation plainly comports with the requirements of the Commerce Clause. Because corporate income and corporate shares reflect equivalent values, the taxable percentage deduction allows the State to avoid duplicative taxation of intrastate commerce. At the same time, taxation of shares issued by firms that are not subject to North Carolina's income tax — firms that fully avail themselves of the benefits of participation in the State's capital market — serves to ensure that interstate commerce "pay[s] its way." *Oregon Waste Systems, Inc.* v. *Department of Environmental Quality*, 114 S. Ct. 1345, 1351 (1994) (citation omitted). Invalidation of that system would work a significant and unwarranted interference with the States' "indispensable power of taxation." *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 329 (1977).

A. This Case Is Controlled By *Darnell* v. *Indiana*

At the outset, this case is quite plainly controlled by the Court's decision in *Darnell* v. *Indiana*, 226 U.S. 390 (1912). As petitioner describes it, *Darnell* involved an Indiana tax on "100% of all stock of [Indiana] residents," with allowance of "a credit or prepayment of taxes paid by a related party — the domestic corporation." Br. 21. But that is a mischaracterization of the case. In fact, *Darnell* involved a tax that was in all essential respects identical to North Carolina's tax on intangibles, and the Court in *Darnell* rejected Commerce Clause arguments indistinguishable from those advanced here by petitioner.

Like the North Carolina tax at issue in this case, the Indiana intangibles tax challenged in *Darnell* was levied on ownership of corporate shares. Indiana taxed all shares both of foreign corporations and of domestic corporations that conducted their business out-of-state; in contrast, the shares of domestic corporations that conducted their business in-state and themselves paid property tax to Indiana were exempt from the intangibles tax, just as the shares of corporations that pay North Carolina's income tax are exempt from that State's levy on intangibles. See *Darnell*, 226 U.S. at 397; *Indiana Dept. of State Revenue* v. *Felix*, 571 N.E.2d 287, 290 (Ind. 1991).[4] The taxpayer in *Darnell* contested the tax

[4] Petitioner describes (at Br. 19) the tax in *Darnell* as one "on stock value imposed on shareholders of domestic Indiana corporations, with a reduction in the tax base dollar-for-dollar as the domestic corporation's property tax base in the State increased. Shareholders of foreign corporations paid property tax on 100% of the value of their stock whether or not the corporation owned property in Indiana." But these were not quite the terms in which the State put the tax. Instead, the State taxed "all shares in foreign corporations * * *, and all shares in domestic corporations when the property of such corporations [was] not exempt or [was] not taxable to the corporation itself. If the value of the stock exceeds

on Commerce Clause grounds, claiming — like petitioner here — that the levy discriminated "in favor of domestic stocks as against shares in a foreign corporation, and that a resident owning stock in a domestic corporation escapes taxation thereon, while his next-door neighbor owning shares of stock in a foreign corporation is required to pay taxes on his holdings." *Darnell* v. *State*, 90 N.E. 769, 773 (Ind. 1912).

The Indiana Supreme Court upheld the tax, using an analysis that closely mirrored that adopted by the court below in this case. The Indiana court explained:

> Domestic corporations are taxed upon all their property. * * * The State, in its discretion, might tax the shares of stock in such corporation to the individual owners thereof residing in this State, but it would in a sense be double taxation, and it has not been the policy of this State to do so. Shares of stock in a foreign corporation doing business in another state, owned and held by a resident of this State, are taxed because they have not been and cannot be otherwise taxed by this State. * * * The man who resides in a state and enjoys the benefits of its schools, churches, society, highways and other public accommodations, as well as its governmental protection over his person and property, is in no position to complain when required to contribute by taxation ratably upon his property for the maintenance of these institutions and the local government. It is clear to our minds that the tax law of Indiana is not open to the charge of discrimination against stock in foreign corporations, but imposes only just and equal burdens upon all corporate stocks, without regard to the place of incorporating or of conducting the corporate business, and does not violate either the third clause of section 8, art. 1, or the 14th amendment to the Constitution of the United States.

Darnell, 90 N.E. at 774.

The taxpayer repeated his argument before this Court, complaining that "[a]s the taxing statutes of Indiana as construed by her courts require all shares of stock in foreign corporations to be listed for taxation, while exempting from taxation, like shares of stock in domestic corporations, they violate the commerce clause of the Constitution." *Darnell*, 226 U.S. at 392. But the Court disagreed, holding in a unanimous opinion by Justice Holmes that "[t]he only difference of treatment [between domestic and out-of-state corporations] * * * is that the State taxes the *property* of domestic corporations and the *stock* of foreign ones in similar cases. * * * [T]his is consistent with substantial equality notwithstanding the technical differences * * *." *Id.* at 398 (emphasis added).

Petitioner's single attempt to distinguish *Darnell* — its assertion that Indiana "simply used the corporate property tax as a prepayment of the shareholder's property tax" (Br. 21) — is wrong both as a description of the levy and as an explanation of the Court's holding. There was no suggestion in Indiana's tax scheme that the payment of property tax by the domestic corporation was a "prepayment" of the shareholder's obligation. See *Felix*, 571 N.E.2d at 290; *Darnell*, 90 N.E. at 773. Instead, the State sought to ensure

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that of the tangible personal property this excess is also taxed." *Darnell*, 226 U.S. at 397. The Court noted that this scheme arguably was problematic because it did "not make allowance if a foreign corporation ha[d] property taxed within the State," but the Court did not address the constitutionality of that distinction because none of the corporations in which the taxpayer held shares was shown to have property in Indiana. *Id.* at 398. The North Carolina scheme does not have any such discriminatory feature; the State *does* make the taxable percentage deduction available to taxpayers who hold shares in foreign corporations that do business in North Carolina.

taxation of all values represented by corporate property that had some connection to Indiana; the property of domestic corporations was subject to a direct tax, while that of foreign corporations was reached through the medium of the intangibles tax on shares. This approach was upheld on the understanding that taxes on the *property* of domestic corporations on the one hand, and on the *stock* of foreign ones on the other, produced "substantial equality." *Darnell*, 226 U.S. at 398.

Petitioner also suggests (at Br. 20) that *Darnell*'s finding of "substantial equality" is inapposite here because both taxes in that case were levied on types of property (tangible property on the one hand and corporate shares on the other, see 226 U.S. at 397). But there is little doubt that the equivalence between the values reached by the income and shares taxes at issue in this case is considerably *stronger* than the relationship between the taxes challenged in *Darnell*. Shares of stock actually derive their value from corporate income, not from corporate property. It thus is uniformly recognized that corporate property is not a strong contributing factor to the value of the corporation's stock; the value of the company's tangible assets matters only when the company is liquidated or sold.

Instead, the market values corporate stock as the present value of the expected future cash flow from the stock, discounted to present value. Because dividends largely determine the stock's future cash flow, and because the corporation's income largely determines the amount of the dividends, the corporation's income provides the best single indicator of the value of its stock. See, *e.g.*, J. Weston & E. Brigham, *Essentials of Managerial Finance* 254-257 (10th ed. 1993); T. Copeland, T. Koller & J. Murrin, *Valuation: Measuring and Managing the Value of Companies* 97 (1990). Accordingly, a tax on corporate income is a *better* proxy for one on corporate shares than is the tax on corporate property upheld in *Darnell* — and a State that wants to "tax only once

the value of stock" (Pet. Br. 20) may do so most effectively by making use of the North Carolina system. *Darnell* therefore dictates the outcome here.

B. North Carolina's Taxes On Intangible Property And Income Are Complementary

Perhaps recognizing that *Darnell* is not fairly distinguishable from this case, petitioner maintains (at Br. 21) that the decision nevertheless should be disregarded because the Court in *Darnell* assertedly did not apply what we now call the compensatory tax doctrine. In this contention, petitioner plainly is incorrect. The Court had recognized and applied the compensatory tax doctrine long before the decision in *Darnell*. See, *e.g.*, *Hinson* v. *Lott*, 75 U.S. (8 Wall.) 148 (1869); *Oregon Waste Systems*, 114 S. Ct. at 1352 (discussing *Hinson*); Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405, 409-410 (1986). Moreover, the test actually applied in *Darnell* — that of "substantial equality" in the taxation of in-state and out-of-state interests — is identical to the one articulated by the Court in its modern compensatory tax decisions. See, *e.g.*, *Boston Stock Exchange*, 429 U.S. at 332 (requirement of "substantially even-handed treatment"); *Oregon Waste Systems*, 114 S. Ct. at 1352 (taxes must be "rough equivalent[s]"). The two courts to have considered the question, the court below in this case and the Indiana Supreme Court in *Felix*, therefore both have concluded that *Darnell*'s "'substantially equivalent events' test is still used today to sustain taxes challenged under the commerce clause." *Felix*, 571 N.E.2d at 291. See Pet. App. 8a-16a. Indeed, this Court very recently cited *Darnell* as a part of its discussion of "paired (or 'compensating') tax schemes that have passed constitutional muster." *Oklahoma*

Tax Comm'n v. *Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1342 n.6.[5]

In any event, the North Carolina intangibles tax plainly does satisfy the requirements of the compensatory tax doctrine as they recently have been described by the Court. "Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause." *Oregon Waste Systems*, 114 S. Ct. at 1352. See *Associated Industries*, 114 S. Ct. at 1821. This principle rests on more than an esthetic concern with symmetry. Instead, its "most powerful justification * * * is constitutional necessity," for "[i]f the Constitution shields the protected interest from taxation under the state's general tax structure, but permits the state to achieve tax equality by other means, a scheme of complementary taxes is a defensible response." Hellerstein, *supra*, 39 Tax Law. at 452. The doctrine thus is "a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means" (*Oregon Waste Systems*, 114 S. Ct. at 1352): it ensures that in-state economic interests will not be disadvantaged by the State's inability to impose identical taxes on out-of-state competitors.

The inquiry whether a compensatory tax produces substantial equality involves a "practical conception" of

[5] In citing *Darnell*, the Court "express[ed] no opinion on the need for equal treatment when a credit is allowed for payment of in- or out-of-state taxes by a third party." *Jefferson Lines*, 115 S. Ct. at 1342 n.6. This is a reference to the feature of the Indiana scheme under which shareholders in domestic — but not foreign — corporations were exempt from the intangibles tax insofar as the corporation paid property tax to Indiana. As we note above (at note 4, *supra*), the Court in *Darnell* also left open the constitutionality of that approach.

discrimination (*Associated Industries*, 114 S. Ct. at 1824, quoting *Gregg Dyeing Co.* v. *Query*, 286 U.S. 472, 481 (1932)), rather than a technical or formalistic one. "The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor precision of technical phrasing in their exercise of the most basic power of government, that of taxation." *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940). Instead, the Court's compensatory tax decisions have looked in a concrete sense to whether in- and out-of-state interests are asked to make equivalent contributions, and whether they do so in a manner that disadvantages interstate commerce.

In conducting this inquiry, the Court has been guided by three considerations. First, the State "must, as a threshold matter, 'identif[y] ... the [intrastate tax] burden for which the State is attempting to compensate.'" *Oregon Waste Systems*, 114 S. Ct. at 1352, quoting *Maryland* v. *Louisiana*, 451 U.S. 725, 758 (1981) (bracketed material added by the Court). Next, "the tax on interstate commerce must be shown roughly to approximate — but not exceed — the amount of the tax on intrastate commerce." *Ibid.* Finally, "the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other." *Ibid.*, quoting *Armco Inc.* v. *Hardesty*, 467 U.S. 638, 643 (1984).

Application of that test here reveals the North Carolina intangibles tax to be a compensatory levy that serves the wholly legitimate and salutary purpose of subjecting those engaged in interstate commerce to their "'just share of state tax burden[s].'" *Oregon Waste Systems*, 114 S. Ct. at 1351, quoting *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 254 (1938). In-state firms that raise funds through North Carolina's capital markets pay for that privilege through the state income tax; out-of-state firms contribute on substantially equal terms to the maintenance of that market

through the medium of the intangibles tax. That tax thus rests squarely on "the settled principle that interstate commerce may be made to pay its way." *Oregon Waste Systems*, 114 S. Ct. at 1351 (citation and internal quotation marks omitted).

1. The Intangibles Tax Compensates for the Income Tax. a. In arguing that the intangibles tax does not validly complement the state income tax, petitioner's principal contention (at Br. 22-24) is that the State's system fails the first prong of the compensatory tax inquiry because there is no in-state burden for which the intangibles tax may properly compensate. This argument is premised on petitioner's assertion that the State is obligated to identify a "burden on intrastate commerce that is being *improperly* avoided by interstate commerce" (Br. 22 (emphasis in original)); because "North Carolina has no right to tax the corporate income earned out-of-state" (*ibid.*), petitioner continues, the State lacks the power to impose a tax that compensates for the one imposed on corporate income earned by in-state firms. See *id.* at 22-23.

This contention, however, reveals a fundamental misunderstanding of the compensatory tax doctrine. In fact, it is the very *point* of the doctrine to permit States to tax values indirectly that they lack the power to tax directly. In the first of this Court's compensatory tax cases, for example, Alabama was permitted to impose a tax on dealers who imported liquor from out-of-state to compensate for a tax imposed on in-state distillers; this approach was necessary precisely because Alabama lacked the power to lay a tax directly on distillers operating in other States. *Hinson*, 75 U.S. (8 Wall.) at 153. And the point is nicely illustrated by the example of compensating sales and use taxes, which petitioner itself recognizes (at Br. 23) as the paradigm of valid complementary taxes. A State that imposes a tax on in-state sales lacks the power to impose a similar levy on out-of-state sellers who make sales to in-state consumers (see, *e.g.*,

Quill Corp. v. *North Dakota*, 504 U.S. 298 (1992)) — in petitioner's terms, it "has no right to tax the [sales made] out-of-state" (Pet. Br. 22). But the State may compensate by taxing the purchaser's in-state *use* of property that was purchased out-of-state. See *Henneford* v. *Silas Mason Co.*, 300 U.S. 577 (1937).

Thus, as a leading commentator has explained,

> In the context of * * * the compensating use tax * * * the Supreme Court has recognized and approved the circuitous measures that the states have taken to achieve tax equality indirectly when the Constitution prohibits them from achieving it directly. In *Henneford v. Silas Mason Co.*, the Court was under no illusion that Washington's compensating use tax was anything other than a device to circumvent limitations that the commerce and due process clause[s] * * * imposed on the state's power to extend its sales tax to goods purchased out of state for local consumption. In describing the relationship of the use tax to the sales tax, the Court acknowledged that "the plan embodied in these provisions is neither hidden nor uncertain." Yet the Court resisted the conclusion that the tax was a "subterfuge" for a tax upon the out-of-state sale because "equality not preference [was] the end to be achieved."

Hellerstein, *supra*, 39 Tax Law. at 453, quoting *Silas Mason*, 300 U.S. at 581, 587, 586. "Hence if the states may not impose their general sales taxes upon out-of-state sales, but may achieve tax equality with regard to all goods purchased for in-state consumption, a compensating use tax on goods purchased out of state designed to produce such equality is a theoretically unobjectionable instrument of state tax policy." *Id.* at 452.[6]

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[6] As Professor Hellerstein has noted, "[t]o be sure, it is strange doctrine that unabashedly permits states to do indirectly what they

Here, of course, the state income tax (or at least that portion of the tax dedicated to maintaining conditions that facilitate the in-state sale of shares) is the "'[intrastate tax] burden for which the State is attempting to compensate.'" *Oregon Waste Systems*, 114 S. Ct. at 1352 (citation omitted). Corporations that do business in North Carolina — whether by owning property, employing a workforce, or generating sales — pay through the corporate income tax for that privilege, in the process supporting the functioning of North Carolina's capital market. Absent the intangibles tax, however, companies whose only connection with North Carolina is the sale of shares to residents of the State would not bear any tax burden, even though those firms take full advantage of the State's services in creating conditions conducive to the raising of capital. In petitioner's case, for example, all but one of the companies in which it owns stock are immune from North Carolina's direct taxing power. Were it not for the intangibles tax, the State would be wholly unable to assess against those companies their fair share of the costs of maintaining North Carolina's capital market. The intangibles tax thus seeks to impose upon those companies, through their shareholders, a burden already borne by in-state firms.[7]

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cannot do directly. * * * But such doctrine, while strange, is firmly embedded in constitutional law." Hellerstein, *supra*, 39 Tax Law. at 453 n.453.

[7] As we explain in more detail below (at 31-33), it does not matter for purposes of the compensatory tax doctrine that the income and intangibles taxes nominally fall on different categories of taxpayers. Indeed, the shares tax raises an issue under the Commerce Clause only to the extent that its effects are felt by the out-of-state issuers of shares, since "[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes." *Goldberg* v. *Sweet*, 488 U.S. 252, 266 (1989). Cf. *West Lynn Creamery, Inc.* v. *Healy*, 114 S. Ct. 2205, 2216 (1994)

b. There is no reason to doubt that in appropriate circumstances a state income tax may serve as the intrastate tax burden for which a compensatory tax properly may be imposed. As a general matter, the Court has been prepared to assume that "various * * * means of general taxation, such as income taxes, could serve as an identifiable intrastate burden roughly equivalent to the out-of-state [tax]." *Oregon Waste Systems*, 114 S. Ct at 1353. And in the particular circumstances of this case, where history makes plain that the income and intangibles taxes were *in fact* regarded as duplicative of one another, the income tax may validly be regarded as an identifiable levy for which the State may impose a compensatory burden on out-of-state entities.

In its initial form, North Carolina's intangibles tax exempted all corporate shares, but was imposed on other intangibles at the same rate as the tax on real property (in 1928, nearly 3%). In that year, the State Tax Commission found that the high rate of the tax caused "many owners of intangibles [to] face virtual confiscation of their income," while other property owners took advantage of the exemption for shares by investing "in stocks to the detriment of other [investments] such as bonds and mortgages." 1928 Report of the State Tax Commission at 342-343, 346.

To address this problem, the State Tax Commission considered the possibility that all intangible property be exempted from tax, explaining that one

> reason advanced for complete exemption is that intangibles are, for the most part, merely paper representatives of real property already taxed. To tax intangibles means, therefore, double taxation. Since double taxation of property is assumed to be undesirable,

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(discriminatory tax formally imposed on in-state taxpayer unconstitutional because it "will result in a disadvantage to the out-of-state producer").

the conclusion seems to follow that intangibles should be exempt.

1928 Report at 352.

Because total exemption of intangible property from tax would produce a substantial revenue loss, however, the Tax Commission considered at greater length the possibility of taxing intangibles at a low rate.[8] With regard to corporate shares, the Tax Commission noted:

> Shares of stock of domestic corporations are now exempt from taxation on the ground that the real and personal property of the corporation has paid its tax, presumably within the state, and that to tax the shares separately would be objectionable double taxation. Also on the ground that *in so far as the corporation has high earning power with little or no tangible property, we are reaching it through our corporate excess tax.*
>
> Shares of foreign corporations, as already pointed out, are at present entirely exempt. If the corporation owns property in this state, it pays on its tangible property but nothing on its corporate excess. If it owns no property in the state, neither it nor the resident shareholder pays anything. It is not the exemption of foreign stock *per se* that is objectionable, but the discrimination involved in exempting stock and taxing bonds and other intangibles.
>
> If shares of stock are made taxable, instead of exempting domestic and taxing foreign shares, a different distinction might well be made. All shares could be exempted to the extent that the property of the corporation is taxed within the state. Conversely all

[8] This would require amending the state constitution, which mandated that intangible and real property be taxed at a uniform rate. N.C. Const. Art. VII, § 9, 1868.

> shares owned by residents could be taxed to the extent that the corporation is not paying within the state on its property. This would mean that if a domestic corporation owned half of its property within the state and half outside, its shares owned by North Carolinians would be exempt only to 50 per cent of their value. If a foreign corporation had 25 per cent of its property in this state, 25 per cent of the value of its shares would be exempt on the part of the owner.

1928 Report at 356-357 (emphasis added).

The system recommended by the State Tax Commission was put in place in 1937, following the amendment of the North Carolina Constitution to permit differential tax treatment of different classes of property. Initially, all corporate shares were subject to tax, with an exemption for "stock in such corporations as pay a franchise and property tax in this State, and the tax upon the proportionate part of their income earned in this State." 1937 N.C. Sess. Laws c. 127 s. 706. The statute was put in something very like its present form two years later, in 1939, when the total exemption for stock issued by a corporation that paid any amount of property, franchise, or income tax was replaced by a proportionate exemption essentially identical to the current taxable percentage deduction. 1939 N.C. Sess. Laws c. 158 s. 705.[9]

[9] The 1939 version of the statute provided:

> [N]or shall the tax apply to shares of stock in corporations which pay to this State a franchise tax on their entire capital stocks, surplus and undivided profits or entire gross receipts * * * together with the tax upon all of the net income, if any, of such corporations. * * * With respect to corporations which pay to this State a franchise tax on part of their gross receipts * * * and a tax upon a part of the net income of such corporations * * * there shall be exempt so much of the fair

Several points come clear from this history. First, the State expressly understood the intangibles tax on shares to reach values that were interchangeable with the property and income taxes — meaning that the taxable percentage deduction was intended to prevent duplicative taxation of in-state values. Second, far from setting out to discriminate against out-of-state firms, North Carolina chose *not* to "exempt[] domestic and tax[] foreign shares," instead exempting "[a]ll shares * * * to the extent" that corporate values already were taxed within the State. 1928 Report at 357.[10] The necessary conclusion is that the income tax is a "specific charge on intrastate commerce" (*Oregon Waste Systems*, 114 S. Ct. at 1352) for which "'the State is attempting to compensate.'" *Ibid.*

2. The Complementary Taxes are Substantially Equivalent. a. As to the second prong of the compensatory tax test, it is evident that the amount of tax imposed by North Carolina on interstate and intrastate commerce is substantially similar. In arguing that this rough equivalence is not good enough, petitioner asserts principally (Br. 25-26) that the

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market value of such shares of stock as is represented by the percentage of net income of which tax is paid to this State.

1939 N.C. Sess. Laws c. 158 s. 705. The reference to the franchise tax was deleted in 1955 (1955 N.C. Sess. Laws c. 1343 s. 2), but the tax on shares otherwise has in relevant part remained essentially unchanged.

[10] The State Tax Commission was referring to the tax on corporate property, as well as to the one on income (or "corporate excess"), as the levy that corresponded to the tax on shares. But in-state property is now taken into account as an element of the income tax apportionment formula. In any event, as we explain above (at 14), a tax on corporate income is a better proxy for the value represented by corporate shares than is one on tangible property.

Court has recognized a "'strict rule of equality'" requiring that the taxes on interstate and intrastate commerce be *identical* in every case. Br. 25, quoting *Associated Industries*, 114 S. Ct. at 1823. This contention, however, reads language from *Associated Industries* wildly out of context, in the process grossly distorting the meaning of that decision.

In referring to a "strict rule of equality," the Court in *Associated Industries* found that routine discrimination against interstate commerce in one set of transactions cannot be supported by discrimination in favor of interstate commerce by *other* jurisdictions in *unrelated* transactions. The Court thus "rejected any theory that would require aggregating the burdens on commerce across an entire State to determine the constitutionality of a burden on interstate trade imposed by a particular political subdivision of the State." 114 S. Ct. at 1822. The Court similarly was unpersuaded by the suggestion "that patent discrimination in part of the operation of a tax scheme, *not directly justified under any theory such as the compensatory tax doctrine*, can be rendered inconsequential for Commerce Clause purposes by advantages given to interstate commerce in other facets of a tax plan or other regions of a State." *Ibid.* (emphasis added).

But the Court in *Associated Industries* plainly did not mean to hold that a compensatory tax scheme must be invalidated in its *entirety* whenever the State is unable to demonstrate a precise dollar-for-dollar equivalence in the burden imposed on in-state and out-of-state taxpayers in *every* case. As a general matter, the Court has characterized "[r]ough approximation rather than precision" as "the norm" in any tax system. *Illinois Cent. R.R.* v. *Minnesota*, 309 U.S. 157, 161 (1940). And just one month before the decision in *Associated Industries* was issued, the Court explained in *Oregon Waste Systems* that "the tax on interstate commerce must be shown *roughly to approximate* — but not exceed — the amount of the tax on intrastate commerce."

114 S. Ct. at 1352 (emphasis added). See *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 77 (1963) (Brennan, J., concurring) ("the Constitution does not mandate absolute equality of treatment as between in-state and out-of-state sales").

That this has long been the Court's approach is demonstrated by *Alaska* v. *Arctic Maid*, 366 U.S. 199 (1961), a decision cited as illustrative of the applicable test in *Oregon Waste Systems*. See 114 S. Ct. at 1352. In *Arctic Maid*, Alaska imposed a 4% tax on the value of fish frozen by Washington-based freezer ships; in practice the frozen fish invariably were transported to Washington for canning. Alaska imposed a distinct tax of 6% on Alaskan canneries, which was measured by the value of fish obtained for canning in Alaska. See 366 U.S. at 200-201, 204. The Court upheld the tax on freezer ships against a Commerce Clause challenge, explaining that

> [w]hen we look at the tax laid on local canners and those laid on "freezer ships," there is no discrimination in favor of the former and against the latter. For no matter how the tax on "freezer ships" is computed, it did not exceed the six-percent tax on the local canners. * * * If there is a difference between the taxes imposed on these freezer ships and the taxes imposed on their competitors, they are not so "palpably disproportionate" * * * as to run afoul of the Commerce Clause.

Id. at 204-205 (citations omitted).[11] See also, *e.g.*, *Dunbar-Stanley Studios, Inc.* v. *Alabama*, 393 U.S. 537, 542 (1969).

Indeed, the same principle comes clear from *Associated Industries* itself, where the Court held that States may impose taxes on interstate and intrastate commerce that are not identical, so long as the greater burden is borne by intrastate businesses. See 114 S. Ct. at 1824. As the Court put it, "in focusing on equality, our cases have addressed the *limit* of permissible state regulation of interstate commerce. In setting the limit at equality, we have not suggested that lesser burdens on interstate trade are impermissible; that is, we have not demanded equality *and nothing but equality* in compensatory tax cases." *Id.* at 1823 n.4 (emphasis in original).

b. That conclusion is dispositive here, for it is undeniable that the burden imposed by North Carolina on interstate businesses will be considerably *lower*, in the vast run of cases, than that imposed on intrastate firms. This point was demonstrated by the court below, which observed that

> corporate income, and income tax paid, are strongly related to the value of the corporation's stock. The strength of this relationship is aptly demonstrated by the fact that economists and investors frequently make use of the "price-earnings ratio," or P/E ratio, which essentially represents the relationship of the value of a corporation's stock to its earnings. See, *e.g.*, 3 The New Palgrave Dictionary of Money & Finance 176 (1992).

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[11] There is a suggestion in *Armco* that *Arctic Maid* involved a statute that "merely laid a nondiscriminatory tax on a particular kind of business, operating freezer ships in Alaska," which "was deemed a different kind of business from operating a cannery in Alaska." 467 U.S. at 643 n.7. But it is apparent from the opinion that "the Court in *Arctic Maid* did not view the business as being different, or at least did not view that as a critical factor." Lathrop, *Armco — A Narrow and Puzzling Test for Discriminatory State Taxes Under the Commerce Clause*, 63 Taxes 551, 559 (1985). Instead, the Court discussed the taxes as being compensatory. The Court accordingly has cited *Arctic Maid*, both before and after the decision in *Armco*, as an application of the compensatory tax doctrine. See *Oregon Waste Systems*, 114 S. Ct. at 1352; *Boston Stock Exchange*, 429 U.S. at 332.

Pet. App. 12a.

The court went on to explain:

> North Carolina taxes corporate income at 7.75 percent and taxes ownership of stock at .25 percent of the taxable value of the stock. Given these tax rates, a North Carolina corporation need only have a P/E ratio less than 31 (7.75/.25) in order to have the tax against its income exceed the intangibles tax against the stockholders of a comparable corporation doing business only in [other States] and having all of its shareholders in North Carolina. Since P/E ratios are only rarely greater than 31, most out-of-state corporations will in fact be paying less taxes to North Carolina, directly in the form of an income tax and indirectly in the form of an intangibles tax against shares, than a similar North Carolina corporation.

Pet. App. 13a-14a (footnotes omitted).[12]

Petitioner pointedly does not challenge the validity of the empirical analysis used below (see Br. 25-26), and accordingly does not deny that the tax burden imposed by North Carolina upon out-of-state firms is *in fact* considerably lower (at least as a general matter) than that imposed upon in-state firms. Indeed, because the number of shares issued by an out-of-state firm that are owned by North Carolina residents will be relatively small (certainly far fewer than 100% of the outstanding shares), the actual dollar amounts paid by the out-of-state firm's shareholders will in almost every case be vastly lower than the amount paid in income tax by a comparable firm whose business is confined to North Carolina. Petitioner therefore contends (at Br. 26) only that

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[12] As the court noted (Pet. App. 14a n.8), the Standard & Poors composite index for P/E ratio during the period 1926-1991 generally was between 10 and 20, and never exceeded 25.

firms doing business across state lines run the risk of being subjected to multiple tax burdens that are not imposed on firms that conduct a wholly intrastate business. That argument, which raises issues under the internal consistency test, is addressed below (at 36-45). But petitioner's contention is simply beside the point for present purposes, for the burdens imposed upon interstate and intrastate commerce *by North Carolina* are equivalent, confirming that the intangibles tax does compensate for the levy on income.

Of course, if a particular taxpayer could demonstrate that the intangibles tax effected a higher levy than the income tax imposed on an equivalent firm whose business is confined to North Carolina, we might agree that the taxpayer would be entitled to relief. But petitioner has not even attempted to make any such showing here. And the possibility — or even, as *Associated Industries* shows, the demonstrated fact — that one set of interstate transactions will be subjected to a discriminatory tax does not invalidate the tax scheme as a whole. The Court has "never deemed a hypothetical possibility of favoritism to constitute discrimination that transgresses constitutional commands. On the contrary, [the Court] repeatedly ha[s] focused [its] Commerce Clause analysis on whether a challenged scheme is discriminatory in 'effect.'" *Associated Industries*, 114 S. Ct. at 1824, quoting *Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263, 270 (1984). There is no such impermissible effect here.

It may be added that the claim of equivalency is not affected by the State's failure to precisely quantify the portion of the corporate income tax dedicated to paying for the privilege of participating in North Carolina's capital markets. Although North Carolina has chosen to assess taxes upon out-of-state corporations using the State's capital markets at a much lower rate than that imposed upon corporations engaging in more widespread activities in the State, it is not constitutionally required to do so. As the Court explained in *Cotton Petroleum Corp.* v. *New Mexico*, "there is no

constitutional requirement that the benefits received from a taxing authority by an ordinary commercial taxpayer — or by those living in the community where the taxpayer is located — must equal the amount of its tax obligations." 490 U.S. 163, 190 (1989). "Interstate commerce may thus be made to pay its fair share of state expenses and contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct benefit." *Jefferson Lines*, 115 S. Ct. at 1346 (emphasis in original; citations and internal quotation marks omitted). See also *Carmichael* v. *Southern Coal & Coke Co.*, 301 U.S. 495, 522 (1937) ("A tax is not an assessment of benefits. It is, as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes."); *Goldberg* v. *Sweet*, 488 U.S. 252, 266 (1989) (no discrimination where tax was not apportioned because it was impossible "to measure the activities within the State" subject to tax).

3. *The Interstate and Intrastate Taxes Fall on Substantially Equivalent Events.* a. The remaining element of the compensatory tax inquiry looks to whether the interstate and intrastate taxes fall on substantially equivalent events. In arguing that the intangibles and income taxes do not satisfy this requirement, petitioner returns to its initial argument with the assertion "that the compensating tax must compensate for the inability to tax an event the state *has the power to tax*," adding that "[t]he intangibles tax is not paid by the same class of taxpayer as the tax purportedly being compensated for and would not be paid upon the same amount or at the same rate." Br. 27 (emphasis in original). We have already addressed the first of these points (see 18-19, *supra*); we add only that, if the State "has the power to tax" a particular event, it is not apparent what would prevent

the State from doing so directly — and what purpose would be served by the compensatory tax doctrine if that were the limits of the principle.

The second portion of petitioner's argument — its contention that a compensating tax must fall upon activities and a class of taxpayers that are identical to those upon which the intrastate levy is imposed — rests on a similarly fundamental misunderstanding of the compensatory tax doctrine. The Court has stated repeatedly that States need not impose the compensatory tax either on the same taxable event or on the same category of taxpayers as the tax for which it compensates: "The end result under the theory of the compensatory tax is that, 'when the account is made up, the stranger from afar is subject to no greater burdens ... than the dweller within the gates. *The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.*'" *Associated Industries*, 114 S. Ct. at 1821, quoting *Silas Mason*, 300 U.S. at 584 (1937) (emphasis added). Indeed, this concept is almost a truism, because if the State could reach the very activity in interstate commerce that is subject to the intrastate tax, there would be no reason to have a separate, compensatory tax in the first place. Thus, the Court has observed that "it is often no mean feat to determine whether a challenged tax is a compensatory tax," indicating that taxes may compensate for one another even when the equivalence between them is not obvious, so long as they are "similar in substance." *Oregon Waste Systems*, 114 S. Ct. at 1352.

In fact,

> [b]y hypothesis, it would seem, the formal equivalence of one tax to another cannot be a criterion of complementarity. The very problem of the complementary tax arises precisely because the levies at issue are not formally equivalent — *i.e.*, they are classified differently or they have distinct legal

incidences. The essential question is whether, despite differences in form, they are equivalent in substance. The Court's precedents finding excise taxes that complement property taxes, use taxes that complement sales taxes, and manufacturing taxes that complement importation taxes stand squarely for the proposition that taxes need not be formally equivalent to one another to be complementary.

Hellerstein, *supra*, 39 Tax. Law. at 431 (footnotes omitted).

The use tax — the paradigm of the valid compensatory tax — again illustrates this point. The Court long has considered use and sales taxes sufficiently equivalent to sustain a compensatory tax defense. The plain fact, however, is that a tax on the sale of goods is different in significant respects from one on the use of goods: they fall upon different events (a sale in the one case and the use of merchandise in the other) that take place in different States and (in petitioner's words) may not be "paid by the same class of taxpayer" (sellers may pay on the one hand and ultimate consumers will pay on the other). Nevertheless, because the taxes fall upon activities generating *values* that are equivalent, the Court has held them to be complementary, ensuring that an out-of-state taxpayer does not use the Commerce Clause as a shield to avoid "pay[ing] its way." *Maryland* v. *Louisiana*, 451 U.S. at 754.

Moreover, as Professor Hellerstein has explained,

It is the rare tax that is the precise functional equivalent of another tax with a different name. Sales and compensating use taxes ordinarily fit this description. * * * None of the other taxes that the Court has considered as complementary, however, can be thought of as functional equivalents in the sense that they were identical except for the label attached to them. In each case there were differences in the substantive nature of the activities or transactions subject to the taxes, in the

measure of the taxes, or in other aspects of the transactions that would render their characterization as "functional equivalents" inaccurate.

Hellerstein, *supra*, 39 Tax. Law. at 432-433 (footnotes omitted).

b. Here, for reasons we already have explained (at 14, 21-24), the intangibles and income taxes are "substantially equivalent" in the sense of the term used by the Court. As a matter of economic reality, there is a close and manifest relationship between the value of corporate shares and the amount of corporate income, which serve as the respective tax bases. This case therefore stands on a decisively different footing from *Oregon Waste Systems*, where the State unsuccessfully asserted that "earning income and disposing of waste at Oregon landfills" — two wholly unrelated activities — were equivalent events. 114 S. Ct. at 1353. In this case, in contrast, the values reached by the shares tax are necessarily and directly dependent upon the values subject to the income tax. The Court, of course, already has reached just that conclusion in *Darnell*.[13]

In fact, *Armco Inc.* v. *Hardesty*, 467 U.S. 638 (1984), the very decision relied upon by petitioner (at Br. 27-28), demonstrates that the taxes here do fall upon substantially equivalent events. There, West Virginia imposed a wholesaling tax on goods sold in-state by out-of-state manufacturers, while imposing a separate manufacturing tax on goods manufactured in-state. The Court rejected the contention that the wholesaling and manufacturing taxes were complementary, explaining (in the very language cited by petitioner at Br. 28) that *"[t]he fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State* * * * makes clear that the manufacturing

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[13] Indeed, as we have explained (at 14), this case is a stronger one than *Darnell* for a finding of equivalence.

tax is just that, and not in part a proxy for the gross receipts tax imposed on [the taxpayer] and other sellers from other States." *Id.* at 643 (emphasis added). Similarly, in *Oregon Waste Systems* the Court turned aside the contention that Oregon's discriminatory tax on the disposal of out-of-state waste compensated for the State's income tax, reasoning that "the very fact that in-state shippers of out-of-state waste * * * *are charged the out-of-state surcharge even though they pay Oregon income taxes* refutes [the State's] argument that the respective taxable events are substantially equivalent." 114 S. Ct. at 1353 (emphasis added). See also *Tyler Pipe Industries, Inc.* v. *Washington State Dept. of Revenue*, 483 U.S. 232, 243 (1987) ("The local sales of out-of-state manufacturers are also subject to Washington's wholesale tax, but the multiple activities exemption does not extend its ostensible compensatory benefit to those manufacturers").

Here, in contrast, firms that pay the state income tax do *not* pay the levy on intangibles, and firms whose shares are subject to the intangibles tax do *not* pay state income tax; the taxes are imposed in precise, inverse proportion to one another. Thus, to invert the analysis of *Oregon Waste Systems*, the fact that in-state firms are *not* liable for the intangibles tax when they *do* pay North Carolina income tax validates the State's argument that the respective taxable events are substantially equivalent. And the history of the levies demonstrates that the taxable percentage deduction was intended to ensure that the State would not impose duplicative taxation on what was understood to be a single corporate value. The taxes thus were expressly intended to, and in fact do, "serve as mutually exclusive 'prox[ies]' for each other." *Oregon Waste Systems*, 114 S. Ct. at 1352. They accordingly are complementary in the truest sense.

As a consequence, the Court's concern in *Oregon Waste Systems* that it might be plunged "'into the morass of weighing comparative tax burdens' by comparing taxes on dissimilar events" simply is not present here. 114 S. Ct. at

1353, quoting *American Trucking Ass'ns, Inc.* v. *Scheiner*, 483 U.S. 266, 289 (1987). We do not contend, as the State did in *Oregon Waste Systems*, that the state income tax may serve as an all-purpose compensatory justification for discriminatory taxes imposed on interstate commerce. Nor does our argument suggest that a State may tax out-of-state businesses more heavily whenever "'the entities involved in interstate commerce happened to use facilities supported by general state tax funds.'" *Oregon Waste Systems*, 114 S. Ct. at 1353 n.8 (citation omitted). Instead, the income and shares taxes here are directly linked in the text of the tax statutes, fall upon demonstrably related values, and are applied as substitutes for one another. That is the paradigm of a system of compensating taxes.

That the values reached by the taxes are substantially equivalent is confirmed by their similar practical effects. Needless to say, the income tax depresses real corporate income, thus driving down the value of the corporation's stock (which is substantially dependent upon income) and discouraging the purchase corporate shares — precisely the (theoretical) effect of the intangibles tax. The income tax thus depresses the flow of capital to North Carolina businesses in much the same way that the intangibles tax impedes the purchase of shares issued by out-of-state firms. That the one tax formally falls upon the corporation and the other upon the shareholder does not detract from this conclusion. After all, the Court has "emphasized that 'equality for the purposes of ... the flow of commerce is measured in dollars and cents, not legal abstractions.'" *Associated Industries*, 114 S. Ct. at 1824 (citation omitted). And "economic equivalence" plainly may exist in such circumstances: "For example, a tax imposed upon and borne by a lessee may be economically equivalent to a tax imposed upon a lessor, if the lessor is able to pass the burden of the tax on to the lessee in the form of increased rent." Hellerstein, *supra*, 39 Tax Law. at 434. Cf. *United States* v.

County of Fresno, 429 U.S. 452, 465 (1977). As we have explained (at note 7, *supra*), that is the case here.

C. The "Internal Consistency Test" Does Not Require Invalidation Of The Taxable Percentage Deduction

As an alternative argument, petitioner asserts that the intangibles tax — even if it satisfies the requirements of the compensatory tax doctrine — must be struck down because it fails the test of "internal consistency" that the Court has used to guide Commerce Clause analysis. But the Court never has applied the internal consistency test to invalidate a state tax in the circumstances of this case, where the challenged levy is a valid compensatory tax that is applied to intangible (and therefore unapportionable) property, and that is designed to reach values that are legitimately subject to tax but otherwise would escape taxation. Applying the test in the manner contended for by plaintiff would require a novel extension of the internal consistency doctrine that would work a substantial and wholly inappropriate interference with state taxing authority.

1. The internal consistency test has been used by the Court to assess "threat[s] of malapportionment." *Jefferson Lines*, 115 S. Ct. at 1338. The test "looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction * * *." *Ibid.* The test is not "a new doctrine that would 'revolutionize the law of state taxation.'" 1 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 4.08[1][a], at 4-43 (2d ed. 1993). Instead, it is a helpful tool for use in rooting out subtly malapportioned or discriminatory taxes. That has been the value of the test in each of the three cases in which the Court has applied it to

invalidate a state tax. See *Scheiner*, 483 U.S. at 285-286 (flat highway tax fails internal consistency test because it effectively imposes per mile cost on interstate truckers that is five times that imposed on intrastate truckers); *Tyler Pipe*, 483 U.S. at 243-244 (tax held not compensatory and therefore discriminatory); *Armco*, 467 U.S. at 642-643 (same). See generally Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 138 (1988).

But the internal consistency test has not been applied in a case like this one where, far from "tak[ing] more than its fair share of taxes from the interstate transaction," the challenged levy is intended to make interstate commerce shoulder its appropriate share of the state tax burden. In making this point, it is important to note at the outset that the out-of-state firms that market their shares to North Carolina residents plainly are benefited by the "laws and amenities" (*Jefferson Lines*, 115 S. Ct. at 1339) of North Carolina in a most concrete way. The State "supplies a number of * * * civic services" that make possible development of the pools of affluent consumers who purchase shares (*D.H. Holmes Co.* v. *McNamara*, 486 U.S. 24, 32 (1988)), and offers the "other advantages of civilized society" (*Goldberg*, 488 U.S. at 267) that are essential for the operation of functioning markets. It thus is evident that the burden indirectly imposed upon out-of-state firms through the medium of the intangibles tax is "tied to the earnings which the State * * * has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes." *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 446 (1940). See *Jefferson Lines*, 115 S. Ct. at 1346 (noting "the usual and usually forgotten advantages conferred by the State's maintenance of a civilized society").

There is, moreover, no requirement that the State demonstrate a dollar-for-dollar correspondence between the benefits that it provides to, and the tax that it imposes on, an

out-of-state commercial enterprise. In fact, determining that value in a case such as this one would be quite impossible. Thus, "[t]he tax which may be imposed on a particular interstate transaction need not be limited to the cost of the services incurred by the State on account of that particular activity." *Goldberg*, 488 U.S. at 267, quoting *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 627 n.16 (1981). Yet absent the intangibles tax, out-of-state issuers of shares — who cannot be reached by the state income tax — could not be required to contribute even indirectly to state coffers.

The Court never has struck down such a tax for failure to comport with the internal consistency test. To the contrary, in *Tyler Pipe*, one of the cases on which petitioner principally relies (see Br. 29-30), the Court expressly distinguished this very situation. There, Washington imposed a wholesaling tax on goods sold in the State and a manufacturing tax on products manufactured in the State; local manufacturers were exempted from the manufacturing tax on the portion of their output that was subject to the wholesaling tax (the so-called "multiple activities" exemption), but were not given an exemption for products sold (and potentially taxed) out-of-state. See 483 U.S. at 236-237. While the Court struck down the multiple activities exemption as discriminatory (see *id.* at 244-248), it also explicitly concluded that imposition of the manufacturing tax on goods sold out-of-state could not "be justified as an attempt to compensate the State for its inability to impose a similar burden on out-of-state manufacturers whose goods are sold in Washington, *for Washington subjects those sales to wholesale tax.*" *Id.* at 244-245 n.12 (emphasis added). Similarly, in *Scheiner* and *Armco*, the other cases in which the Court has applied the internal consistency test to invalidate state taxation, the out-of-state taxpayer unquestionably was subject to direct taxation and therefore bore its fair share of state tax. See also *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983). Here, in contrast, North Carolina is unable to impose a fair burden on out-of-state issuers of shares except through the medium of the intangibles tax.

Indeed, the Court never has applied the internal consistency test to invalidate an otherwise valid compensatory tax. In both *Armco* and *Tyler Pipe*, the Court went to considerable lengths to demonstrate that the state taxes at issue were *not* truly complementary — analyses that would have been wholly unnecessary had compensatory taxes been invalid under the internal consistency principle. See *Armco*, 467 U.S. at 642-643; *Tyler Pipe*, 483 U.S. at 242-244. See also *id.* at 253 (O'Connor, J., concurring); *Scheiner*, 483 U.S. at 302-303 (O'Connor, J., dissenting). And in *Scheiner*, the Court specifically noted that the flat tax at issue was *not* defended as "a compensatory tax that equalizes previously unequal tax burdens by offsetting 'a specific tax imposed only on intrastate commerce for a substantially equivalent event.'" 483 U.S. at 287 (citation omitted).

Ruling for petitioner accordingly would require the Court to make considerable new law. In fact, petitioner itself acknowledges (at Br. 33-34) that it can prevail only if the Court overrules *Darnell*. Petitioner's theory also would require the Court to overrule *Hinson* v. *Lott*, the venerable decision that the Court recently cited with approval as the fountainhead of the compensatory tax doctrine. *Oregon Waste Systems*, 114 S. Ct. at 1352. See Hellerstein, *supra*, 87 Mich. L. Rev. at 152-153 (discussing *Hinson*). Petitioner has not offered the Court any reason to take such a substantial step. By definition, after all, the combination of North Carolina taxes, because compensatory, does not work an impermissible discrimination against interstate commerce. And the tax cannot be considered malapportioned where the out-of-state corporation pays (in part indirectly though the shares tax) for the distinct benefits provided by the several States that facilitate its business.

2. Even if the internal consistency test would invalidate other sorts of complementary taxes, it should not be applied to strike down a tax on intangible property. Because intangible property has no identifiable location and may draw benefits from many jurisdictions, the Court has long held that taxes on such property need not be apportioned even though this may result in what appears to be duplicative taxation. Thus, a State may tax the full value of intangible property that has a situs in that State, even though the State of the taxpayer's domicile also may impose an identical tax on the same property. See *Curry* v. *McCanless*, 307 U.S. 357 (1939); *State Tax Comm'n* v. *Aldrich*, 316 U.S. 174 (1942).[14] In such a situation, where no single State has exclusive control over the value subject to tax, where more than one State provides benefits and protections to the taxpayer, and where apportionment of the value taxed cannot meaningfully be achieved, unapportioned taxation is consistent with the Constitution.[15]

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[14] Similarly, the Court has held that a State may tax the entire income of its residents even though it also taxes an apportioned share of income earned in-state by nonresidents — a regime that would lead to multiple taxation if duplicated by other States. See *New York ex rel. Cohn* v. *Graves*, 300 U.S. 308 (1937); *Lawrence* v. *State Tax Comm'n*, 286 U.S. 276 (1932); *Shaffer* v. *Carter*, 252 U.S. 37 (1920).

[15] As Justice Stone wrote for the Court in *Curry*, 307 U.S. at 367-368 (footnote omitted):

> [W]hen the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and laws of another state [in addition to his State of domicile], in such a way as to bring his person or property within reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax.

While the decisions cited above in text involved the apportionment requirement of the Due Process Clause, there is no reason to doubt that they also state principles controlling under the Commerce Clause. Cf. *Shaffer*, 252 U.S. at 56-57 (rejecting Commerce Clause challenge to statute that raised possibility of multiple taxation of income of domiciliaries); *Commercial Credit Consumer Services, Inc.* v. *Norberg*, 518 A.2d 1336 (R.I. 1986) (State permitted to tax entire net income of domestic corporation).[16] In this connection, we note that in *Ford Motor Credit Co.* v. *Department of Revenue*, 500 U.S. 172 (1991), an equally divided Court affirmed a decision of the Florida Court of Appeal upholding

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> * * * [I]t is undeniable that the state of domicile is not deprived, by the taxpayer's activities elsewhere, of its constitutional jurisdiction to tax, and consequently that there are many circumstances in which more than one state may have jurisdiction to impose a tax and measure it by some or all of the taxpayer's intangibles. Shares of corporate stock may be taxed at the domicile of the shareholder and also at that of the corporation which the taxing state has created and controls; and income may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit, and power over the subject matter are not confined to either state.

Cf. *Allied-Signal, Inc.* v. *Director*, 112 S. Ct. 2251, 2262 (1992) (non-business corporate *income* from intangibles is, as a matter of practice, allocated by statute to the corporation's state of domicile).

[16] The apportionment analysis under the Due Process and Commerce Clauses is identical. See, *e.g.*, *Container Corp.*, 463 U.S. at 169; *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207, 227-228 (1980). And because any discrimination against interstate commerce in this case is overcome by the compensatory tax doctrine, the combination of North Carolina's income and intangibles taxes may be vulnerable, if at all, only to a claim of malapportionment.

Florida's property tax on intangibles, which permitted unapportioned taxation both by the owner's State of domicile and by the State where the intangibles had their business situs. Rejecting a Commerce Clause challenge, the court of appeal reasoned that "since [the taxpayer] has extended its activities regarding its intangibles to Florida and has availed itself of the benefits of the laws of several states with regard to this property, those several states, including Florida, may each impose a tax upon such intangible property." *Ford Motor Credit Co.* v. *Department of Revenue*, 537 So.2d 1011, 1012 (Fla. Ct. App. 1988). The court of appeal added that the internal consistency test would not invalidate such a property tax. See *id.* at 1013.

Petitioner's approach cannot survive application of this principle. Petitioner complains (at Br. 31) that North Carolina's tax regime, if adopted by every State, could lead to increased or duplicative burdens on firms that sell their shares across state lines.[17] But that is the nature of intangible property, and of corporate shares in particular; because such property may be provided distinct benefits by more than one State, it long has been subject to unapportioned taxation by more than one State. Firms that sell their shares across state lines therefore subject those

[17] We note that petitioner's argument (at Br. 31) that the intangibles tax is invalid because it might impose increased burdens on North Carolina firms that engage in interstate commerce cannot be reconciled with the Court's holding in *Goldberg* that "[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes." 488 U.S. at 266. See *id.* at 268 (Stevens, J., concurring in part and concurring in the judgment) (noting Court's holding that a State "may discriminate among its own residents by placing a heavier tax on those who engage in interstate commerce than on those who merely engage in local commerce"); *id.* at 270 (O'Connor, J., concurring in part and concurring in the judgment) (same).

shares to additional taxation. This may be explicable as a function of the practical impossibility of apportionment: unlike a multistate corporation's income, which has distinct and identifiable sources (and hence is apportionable), the values represented by intangibles may be thought to exist in (and receive equivalent protections from) two States. And where apportionment is not practical, the internal consistency test will not be used to invalidate a tax. See *Scheiner*, 483 U.S. at 297 (flat tax permissible where "administrative difficulties make collection of more finely calibrated user charges impracticable"); *Goldberg*, 488 U.S. at 266 (discrimination claim rejected where it was not "possible to measure the activities within the State").

3. Petitioner's answer to this problem is to insist (at Br. 32) that the State either forgo any tax on intangibles or impose the intangibles tax on precisely equivalent terms to the shares of both in-state and out-of-state corporations. But this approach places the State on the horns of a dilemma. Elimination of the tax would force the State to abandon any effort to get out-of-state firms to make their fair contribution to the maintenance of the North Carolina capital market in which they participate. And offering the shareholders of such corporations a credit against their intangibles tax for income taxes paid by the issuing corporation to *other* States (which would parallel the taxable percentage deduction offered to the owners of shares issued by corporations doing business only in North Carolina) would not be a workable approach. Again, that would mean that corporations that conduct all of their business outside of North Carolina but sell shares within the State — including five of the six firms in which petitioner holds shares — would entirely escape any obligation to shoulder their fair share of the state tax burden.[18]

[18] That is not true of conventional sales/use tax regimes. It is true that States imposing use taxes almost universally provide a credit for sales taxes previously paid either in- or out-of-state. See

On the other hand, requiring the State to impose the intangibles tax on the shares of both intrastate and interstate firms without the taxable percentage deduction would subject intrastate commerce to duplicative taxation. Petitioner forgets that we are here proceeding on the hypothesis that the income and intangibles taxes satisfy the requirements of the compensatory tax doctrine. As a consequence, for present purposes it must be deemed established that the two taxes are imposed on equivalent values — and that the taxable percentage deduction furthers a legitimate local purpose (that of avoiding duplicative taxation on in-state firms) that cannot be achieved by nondiscriminatory means. See pages 16-17, *supra*. Requiring the State to disregard that purpose by subjecting intrastate commerce to duplicative taxation would contravene the fundamental principle that the Commerce Clause was not designed to "place such [interstate] commerce in a privileged position." *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 623 (1981).

In this situation, the Court should apply "the understanding that the Commerce Clause does not forbid the actual assessment of a succession of taxes by different States on distinct events." *Jefferson Lines*, 115 S. Ct. at 1339-1340. To be sure, the Court in *Jefferson Lines* was discussing a succession of internally consistent taxes that formally fall on discrete activities. But that principle also should be applicable in the unusual circumstances of this case, where the State in which the interstate firm produces income and the State in which the firm's shareholders reside each provides benefits that facilitate the interstate firm's business. Cf. *id.* at 1339. Because the value represented by intangible property is not practically apportionable, because each of the taxing States "would presumably have * * * an equal claim on the taxpayer's purse" (*id.* at 1343), and because North Carolina has a compelling interest in avoiding duplicative taxation of intrastate commerce, the taxable percentage deduction should not be held invalid under the internal consistency test.

Jefferson Lines, 115 S. Ct. at 1343; *Tyler Pipe*, 483 U.S. at 245 n.13. But because it generally has been thought that States may not impose sales taxes on the sale of products shipped out-of-state (see, *e.g.*, *Evco* v. *Jones*, 409 U.S. 91, 93 (1972)), businesses (such as mail order firms) that ship products to other States are not subject to a sales tax, and therefore have nothing to credit against use taxes imposed by the State of purchase.

D. If The Taxable Percentage Deduction Is Held Unconstitutional, The Case Should Be Remanded For Determination Of A Remedy

Finally, if the Court does hold the taxable percentage deduction unconstitutional, it should remand the case to the state courts so that they may determine the appropriate remedy. Petitioner also evidently recognizes (at Br. 9) that it is for the state courts to decide any remedial issues in the first instance. It is settled that a finding of unconstitutionality "does not in itself dictate the relief that the State must provide." *Associated Industries*, 114 S. Ct. at 1825. Even assuming that the decision invalidating the tax is given retroactive effect, "the Due Process Clause would demand only that, 'to cure the illegality of the tax as originally imposed, the State must ultimately collect a tax for the contested period that in no respect impermissibly discriminates against interstate commerce.'" *Ibid.*, quoting *McKesson Corp.* v. *Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 44 n.27 (1990).

A State in such a situation may remedy unconstitutionality by retroactively raising taxes on the favored class, by offering refunds or credits to the disfavored class, or by some combination of the two. See *Associated Industries*, 114 S. Ct. at 1825; *McKesson*, 496 U.S. at 40 & n.23. But so long as the State's choice comports with the U.S. Constitution, the question of remedy is one of state law

that should be settled by the state courts. See generally *Hooper* v. *Bernalillo County Assessor*, 472 U.S. 612, 624 (1985); *Zobel* v. *Williams*, 457 U.S. 55, 64-65 (1982). "The methods best adapted to achieving equal treatment in this case, whether partial or complete refunds or other measures, are similarly matters left for determination on remand." *Associated Industries*, 114 S. Ct. at 1825.

CONCLUSION

The judgment of the North Carolina Supreme Court should be affirmed.

Respectfully submitted.

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JULY 1995

(7)

No. 94-1239

In the Supreme Court of the United States

OCTOBER TERM, 1994

FULTON CORP., *Petitioner*

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE, *Respondent*

On Writ of Certiorari to the Supreme Court of North Carolina

RESPONDENT'S REPLY IN SUPPORT OF THE MOTION TO DISMISS THE WRIT OF CERTIORARI AS IMPROVIDENTLY GRANTED

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RESPONDENT'S REPLY IN SUPPORT OF THE MOTION TO DISMISS THE WRIT OF CERTIORARI AS IMPROVIDENTLY GRANTED

Petitioner's response to the motion to dismiss the writ of certiorari as improvidently granted substantially confirms the motion's principal points. Petitioner carefully does *not* assert that repeal of the challenged tax was motivated by this Court's decision to grant review. Petitioner does *not* suggest that other taxes in other States would be affected by this Court's decision in this case. And petitioner evidently

recognizes that it would *not* be guaranteed a tax refund by a victory on the merits in this Court. In these circumstances, we respectfully suggest that it would be appropriate for the Court to dismiss the writ of certiorari as improvidently granted.

1. Petitioner's principal contention (Resp. 5-9) is that repeal of the intangibles tax was part of a Machiavellian scheme on the part of the State to retain unconstitutionally collected taxes when judicial review was imminent. That is demonstrably incorrect. We explain in the motion (at 3 n.1), and petitioner does not deny, that the intangibles tax surely would have been repealed even if this Court had denied review: the bill to repeal the tax was introduced and was approved by both Houses of the State Legislature *prior* to this Court's grant of certiorari, at a time when the tax had been *upheld* by a unanimous North Carolina Supreme Court and there was no reason to anticipate further review. This cannot fairly be characterized as a "state ploy[] to retain the fruits of unconstitutional taxes" (Resp. 6) and hardly serves as a model for future attempts to deny tax refunds. Indeed, the Legislature's decision to repeal the entire intangibles tax as it relates to corporate shares, rather than only the taxable percentage deduction challenged here, makes manifest that it was dissatisfaction with the tax, and not any intent to evade judicial review, that motivated legislative action.

2. Petitioner makes virtually no attempt to demonstrate that the legal issue presented here is of any continuing importance anywhere in the Nation. Although petitioner asserts in conclusory terms the "broader significance" of this action (Resp. 9), it points to *no* tax in *any* State whose validity would be affected by a decision on the merits in this case. And while petitioner asserts that state courts need guidance on the vitality of *Darnell* v. *Indiana*, 226 U.S. 390 (1912), that case has been cited only twice by state courts in the last 20 years: once by the courts below and once by the Indiana Supreme Court when that court considered the

validity of Indiana's since-repealed intangibles tax. *Indiana Dept. of State Revenue* v. *Felix*, 571 N.E.2d 287 (Ind. 1991).[1] It accordingly is quite clear that an opinion in this case addressing *Darnell* would be essentially advisory in nature.

3. Although petitioner asserts that it is entitled to a refund (Resp. 10), it ultimately acknowledges that it might very well *not* obtain a refund even if it prevailed on the merits of its Commerce Clause claim. Petitioner thus acknowledges that the State could cure the asserted discrimination by retroactively increasing the taxes of in-state beneficiaries of that discrimination -- and petitioner does not deny that such an increase would, as a practical matter, do it no good at all. See Mot. 5 n.2. Moreover, petitioner makes *no* response to our demonstration (at Mot. 5) that its probability of prevailing on remand is minimal in light of the state court of appeals' holding *as a matter of state law* that the taxable percentage deduction should be severed from the remainder of the tax code. At bottom, then, petitioner would have the Court decide a question of no continuing importance that in all likelihood would not affect even the substantial rights of the parties to this litigation.[2]

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[1] *Darnell* has been cited by state courts on only two other occasions since 1960. Once was for the boilerplate observation that "[t]o proceed with an argument based on the equal protection of the laws, a party must at least show that he has been discriminated against by the statute or action against which he complains." *People* v. *Adams*, 350 N.E.2d 767, 772 (Ill. App. 1976). The other was for the equally unexceptional point that "the court must determine that the party seeking to raise a constitutional claim or defense has shown that he has the requisite standing to do so." *Board of Commissioners* v. *Kokomo City Plan Comm'n*, 330 N.E.2d 92, 95 (Ind. 1975).

[2] It may be added that prevailing on the merits also would not entitle petitioner to its attorneys' fees in light of *National Private*

In making this argument, we plainly do not contend, as did the State in *Texas Monthly, Inc.* v. *Bullock*, 489 U.S. 1 (1989), that petitioner lacks standing to pursue its claim. Instead, we suggest as a prudential matter that it makes little sense for the Court to devote its resources to the resolution of an issue that almost certainly will not recur. Indeed, in an important respect the citation to *Texas Monthly* offered by petitioner (at Resp. 11-12) supports our point by noting that the choice of remedy in a case involving a constitutional challenge to state taxation (in this case, whether retroactively to increase taxes rather than grant a refund) is a matter of state law.

4. Petitioner is simply incorrect in its further contention (at Resp. 9-10) that the Court has not dismissed the writ in circumstances such as this one, where repeal of the challenged statute did not give the complaining party retroactive relief. In *Morris* v. *Weinberger*, 410 U.S. 422 (1973), for example, the statutory amendment did not, as petitioner would have it (at Resp. 9), "retroactively g[i]ve the petitioner the right sought." To the contrary, the Court dismissed the writ in that case even though "the new Act d[id] not provide coverage for petitioner's child but the old Act remain[ed] applicable to the claim before [the Court]." *Id.* at 424 (Douglas, J., dissenting). See also, *e.g.*, *Triangle Improvement Council* v. *Ritchie*, 402 U.S. 497 (1971) (Harlan, J., concurring) ("To the extent * * * that the instant case has any significance for the future, it seems to me that such issues should await a case arising under the new statute.").

Truck Council, Inc. v. *Oklahoma Tax Comm'n*, No. 94-688.

In these circumstances, it would be appropriate for the Court to dismiss the writ of certiorari as improvidently granted.

Respectfully submitted.

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JUNE 20, 1995

(10)

No. 94-1239

IN THE
SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,

Respondent.

On Writ of Certiorari to the
Supreme Court of North Carolina

REPLY BRIEF FOR THE PETITIONER

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27 pp

QUESTION PRESENTED

Whether the North Carolina intangible personal property tax on the value of corporate stock owned by shareholders discriminates against interstate commerce in violation of the United States Constitution by taxing one hundred percent of the value of stock of corporations that do no business in North Carolina, but exempting from taxation the stock of corporations that do business only in North Carolina, and reducing the taxable value of the stock of other corporations proportionately as the amount of business done by the corporation in North Carolina increases.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, petitioner Fulton Corporation states that it has neither a corporate parent nor a corporate subsidiary.

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IN THE

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REPLY BRIEF FOR THE PETITIONER

INTRODUCTION

The Secretary admits, as she must, that the intangibles tax discriminates against interstate commerce, both facially and in operation. Resp. Br. 9, 10, 44. Her

new theory of why it is a constitutionally permissible compensating tax is preposterous.

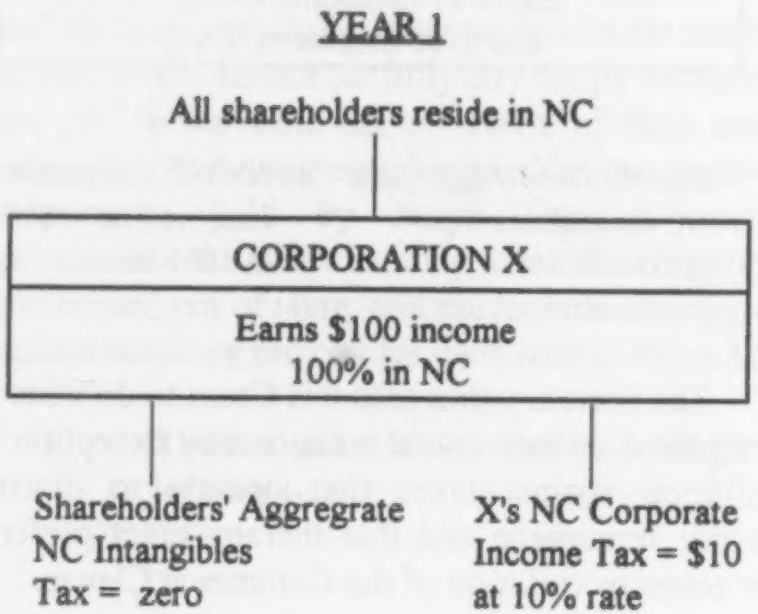
There is no evidence, admissible or otherwise, that the intangibles tax on stock was designed or intended to make multistate corporations pay "for the privilege of participating in North Carolina's capital markets." Resp. Br. 29. The Secretary never mentioned this new theory in this case prior to filing the Brief of Respondent, and the North Carolina Supreme Court did not utilize it in this case. The entire history and structure of the corporate income and intangibles taxes show that one taxes corporate income earned from business activity in the state and the other taxes intangible property having a business situs, or owned by residents, in the state. Neither is a tax *upon* access to capital markets.

The two taxes by definition are not equivalent. The income tax varies *only* and directly with income earned from business activity in the state. The aggregate intangibles tax paid by all of a corporation's North Carolina shareholders varies directly with the proportion of corporate income earned out of state, directly with the number of shares held by residents of the state, and directly with the value of the shares.

Unlike any other compensating tax scheme that this Court has upheld, this scheme *causes* discrimination against interstate commerce by operating to exert an inexorable hydraulic pressure on interstate commerce to ply their trade within North Carolina. As illustrated below, the stock tax increases as the proportion of corporate

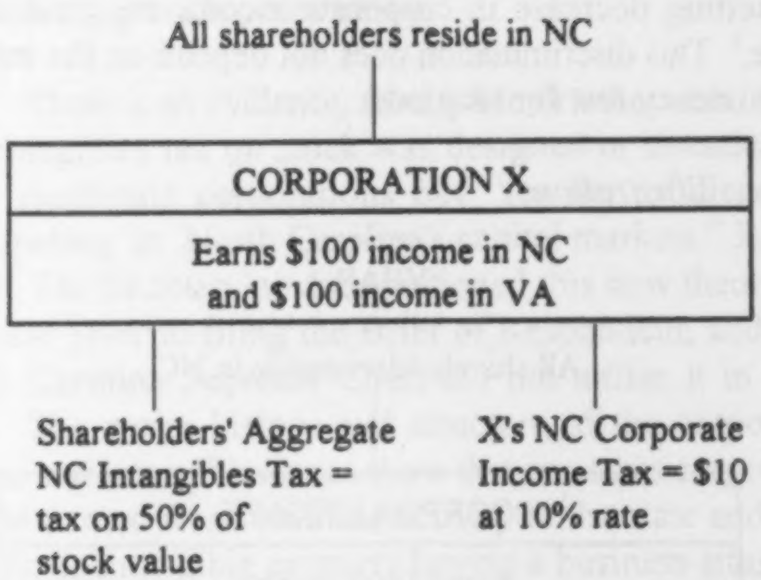
income earned out of state increases, with no necessary offsetting decrease in corporate income tax paid to the state.[1] This discrimination does not depend on the internal consistency test for its proof.

Illustration:



[1]Resondent's Brief at 34 incorrectly implies that the income tax decreases as the aggregate stock tax increases.

YEAR 2



The Secretary thus asks this Court to do what it has never before done -- create a major new exception to the prohibition against taxes that operate to discourage interstate commerce and that thereby erect preferential trade zones in violation of the Commerce Clause.

ARGUMENT

A. The North Carolina Corporate Income Tax is Not a Levy on Intrastate Commerce for Which the State Needs to Compensate.

The Secretary's Brief understandably spends far more space discussing constitutional principles than analyzing the practical applications of her new theory. The major premises of the Secretary's new theory, summarized in the most favorable light, are: (1) one of the "state's

services" for which the corporate income tax is levied is the maintenance of the state's "capital market" (Resp. Br. 20); (2) the income tax is an intrastate tax burden on corporate income earned in the state, which is charged in part for this service; (3) the state can compensate therefor by indirectly taxing (through a tax on their stocks)[2] corporations that purportedly enjoy the purported "state service" because they have shareholders in the state, but do not pay for the service (or fully pay for it) because they do not pay to the state tax on 100% of their income; consequently, (4) the aggregate[3] intangibles tax on stock of a corporation held by North Carolina residents compensates for the state's inability to tax the corporation's income earned out of state, and the income and aggregate intangibles taxes are proxies for each other. Resp. Br. 14.

1. The Secretary's new theory is illogical on its own terms.

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[2]The Secretary's Brief goes to great lengths to argue that the stock tax is not *on* the shareholder but is *on* the corporate income or property. See Resp. Br. 13-14, rejecting Fulton's characterization of the stock tax in *Darnell* as a tax on stock, prepaid by the corporation, and insisting that the stock tax is an indirect tax on the corporation's income.

[3]See Resp. Br. 7 (referring to the aggregate "tax liability of its shareholders"); 28 (quoting the opinion of the Supreme Court of North Carolina referring to the aggregate of "intangibles tax against shares").

The Secretary's Brief created out of whole cloth the novel theory that North Carolina enacted the discriminatory deduction in its intangibles tax on stock in order to make multistate corporations indirectly pay for "their fair share of the cost of maintaining North Carolina's capital market." Resp. Br. 20. The theory is illogical because it has no consistent explanation of how that fair share is measured. *See Oregon Waste Systems, Inc. v. Dept. of Env. Quality*, 114 S. Ct. 1345, 1352-1353 (1994) ("Respondent's failure to identify a specific charge on intrastate commerce equal to or exceeding the surcharge is fatal to their claims.")

The only remotely logical ways the "fair share" argument could work would be that either (1) the "fair share" is direct or indirect (through the intangibles tax) tax on 100% of a corporation's income, or (2) the "fair share" is direct or indirect (through the income tax) tax on so much of a corporation's stock value as is held by residents of the state. The Secretary's argument focuses almost entirely on showing the stock tax to be an indirect tax on income, or the income tax to be an indirect tax on stock, without addressing the facts that the income tax *does not vary with stock ownership* in the state and that the aggregate stock tax is not a proxy for tax on all of the income earned out of state because it *applies only to the extent* of shares held in the state.

Illustration:

99 shares owned by VA residents	1 share owned by NC residents
Corporation X	
Earns income in VA of $100	Earns income in NC of $100
Aggregate NC Intangibles Tax = indirect tax on $1 (1%) of VA income of $100[4]	X's NC Income Tax = tax on $100, which is 100% of NC income

This *Illustration* shows that neither is the North Carolina corporate income tax a proxy for the aggregate stock tax, nor is the aggregate stock tax a proxy for the North Carolina income tax.

Furthermore, the residence of shareholders has no necessary relation to the corporation's intentionally accessing the state's capital market by selling stock to

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[4] The value of 1 share minus 50% of the value of one share times the intangibles tax rate is the intangibles tax, which is a proxy for an indirect tax on 1% of X's VA income, under the Secretary's new theory.

North Carolina residents through channels of commerce in the state.[5]

Thus, the new theory is illogical and arbitrary on its own terms. This illogic shows that intentional adoption of the taxing scheme at issue for the asserted purpose cannot be inferred, particularly in the absence of any extrinsic evidence of such purpose, as discussed below in section 2.

The theory's illogic is rooted in its confusion of the existence of the myriad of benefits of living in an organized society (of which the presence of a capital market may be one) with the levying of a tax *upon* a particular event or subject. The corporate income tax is not levied *upon* any event that can be related to access to capital market, and therefore it bears no logical relation to the intangibles tax on stock, even if that tax could be viewed as somehow related to access to the capital market. Consequently, the two taxes cannot be linked into a logical regime for purportedly taxing access to capital markets.

The Secretary cannot distinguish *Oregon Waste*, 114 S. Ct. 1345. Oregon also tried to portray "general taxation" as the intrastate tax to be compensated for by a per unit tax on out-of-state waste disposal. The Court stated that earning income (for purposes of general income taxation) was not equivalent to waste disposal. The

[5]*Cf.* Resp. Br. 17, 20, which incorrectly characterizes the intangibles tax as one imposed on *selling* stock in North Carolina.

Secretary argues that corporate income and stock values are somewhat more interrelated (Resp. Br. 33) (although it also could be said that the more waste one disposes of, the more income one probably would have). Even if that were so, the corporate income tax is not levied upon an *event* and a tax base similar to that on which the intangibles tax is levied - aggregate of stock owned by residents - and *vice versa*.

As a further analogy to *Oregon Waste*, the aggregate stock tax here can go up when the income tax paid to North Carolina remains constant, this occurring on account of the corporation earning additional income out of state as illustrated in the Introduction, above. Therefore, contrary to the Secretary's assertion, her new theory *does* make the fallacious argument that "the state income tax may serve as an all-purpose compensatory justification for discriminatory taxes imposed on interstate commerce." Resp. Br. 35.

Finally, the tax in *Darnell v. Indiana*, 226 U.S. 390 (1912), which the Secretary contends is "in all essential aspects identical," was not justified as a tax on the corporation's access to the capital markets, but as a tax for the resident *shareholder's* benefits from the state. Resp. Br. 11-13 (quoting the Indiana Supreme Court).

2. The Secretary has offered no proof for her new theory of the compensatory function of the stock tax.

The opinion below of the North Carolina Supreme Court did not mention the Secretary's new theory and neither has the Secretary in over four years of litigation in this case in the trial court, the North Carolina Court of Appeals, the Supreme Court of North Carolina, or in her two prior submissions to this Court in this case.

The "purpose" of the corporate income tax is the imposition of "a tax for the use of the State government upon the net income of every domestic corporation and of every foreign corporation doing business in the State." N.C. Gen. Stat. §105-130.1. "Doing business" is "the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following: [none of which has anything to do with selling stock] . . . ." N.C. Admin. Rule 17:5C.0102. The intangibles tax on stock is a *property* tax levied under Article V, §2(2) of the North Carolina Constitution, which authorizes *property* taxes. N.C. Gen. Stat. §105-198.

The extra-record submission lodged by the Secretary with the Court contains no hint of the new theory. Her Brief points only to a single sentence in a 1928 Report to the Governor justifying the then current system of *not* taxing domestic corporate stock, by a reference to the imposition of both the domestic property tax and excess profits tax. Resp. Br. 21-23. The Secretary has established no causal or factual linkage between the 1928 Report and the 1939 enactment of the taxing regime at issue. Contrary to the assertion in the Secretary's Brief, that Report *did not* recommend exempting shares to the extent the issuing corporation paid income tax to the state.

Resp. Br. 4, 22-23. The Secretary offered no evidence that even the 1937 version of the intangibles tax constituted an intentional adoption of part of the Report's recommendations.

Fulton's evidence in the record before this Court includes the deposition of the knowledgeable state employee, Frank Goodrum, Jr., who became an intangibles tax auditor in 1958, assistant director of the Intangibles Tax Division in 1967 and Director in 1977, continuing to the time of the deposition in 1991. Goodrum Depo. 4-5. He was asked about the purpose of the intangibles tax and the deduction and he supplied under subpoena two explanations prepared in his Department of the tax. His explanations clearly identify the purpose of the deduction as avoidance of double intrastate taxation *of property*, and made no reference to the novel theory now espoused by the Secretary.[6] Goodrum Depo. 25-34.

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[6]He stated his understanding to be that the multistate corporation that paid tax on 30% of its income to North Carolina was *presumed to have 30% of its property in North Carolina*, where it paid tax on that property. Goodrum Depo.28. He stated that there was no factual account of that theory. Goodrum Depo.29. Attached to his deposition as Exhibits 4 and 5 are histories of the intangibles tax on stock written by the Department of Revenue that give no explanation of the stock tax deduction. These two exhibits were the fruits of a search within the Department for any explanation of the operation of the tax. Goodrum Depo. 63-64.

Finally, the theory that the intangibles tax is a tax on corporate access to capital markets is refuted by the fact that North Carolina has chosen to "charge" for all the privileges available to a business entity in the state through the franchise tax, which is distinct from the corporate income tax. N.C. Gen. Stat. §105-114 (imposing the franchise tax "for the benefit and protection which such corporations receive from the government and the laws of this state in doing business in this state . . . " and defining doing business as "Each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State"). In addition, North Carolina specifically regulates the privilege of access to its capital markets by the Blue Sky Law, N.C. Gen. Stat. §78A-24 et seq. In connection therewith the state charges securities registration and filing fees. N.C. Admin. Rule 18:6.1304. Aside from the securities registration, a foreign corporation selling its shares to residents of the state through national markets would not even have to register to do business in North Carolina for the "privilege" of access to capital markets. N.C. Gen. Stat. §55-15-01(b).

3. There is no intrastate tax on a substantially equivalent event for which North Carolina needs to compensate.

Fulton does not deny North Carolina's power to tax the stock at 100% of value, and possibly even the power to tax it for this "state service" if the state so desires. Fulton disputes the discriminatory deduction allowed in computing the tax on stock, which has the effect of

converting the aggregate stock tax into a tax on corporate income earned out of state. See Pet. Br. 22-23.

Undoubtedly the Secretary belatedly developed the "capital market" theory in her effort to fulfill the compensating tax defense requirement of a common underlying subject that is taxed upon nominally different but substantially equivalent events, so that one tax can be called a proxy for the other. That is, the compensated and compensating taxes must be bound together as in a triangle, with both being linked to a common subject of taxation: the intrastate part of that common subject is taxed by the compensated tax and the interstate part is taxed by the compensating tax. There is no such linkage here.

In the paradigm compensating tax example of the sales and use taxes, the common taxing subject is the consumption in the state of the goods bought. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1345 (1995), which recognizes that the taxable events of the sales and use taxes are different - the sales tax falls on the "freedom of purchase," while the use tax falls on the use. The opinion goes on to state, however, that the sales tax is imposed only when the sale is "for consumption." 115 S. Ct. at 1339 and 1341. *See also Associated Indus. of Mo. v. Lohman*, 114 S. Ct. 1815, 1821 (1994) (identifying the purpose of the sales-use tax scheme as making all property "used or consumed in the state subject to a uniform tax burden.") Consequently, the use tax is a proxy for the sales tax as a tax on consumption in

the state and for that reason the sales and use taxes fall on substantially equivalent events and bases.[7]

Illustration:

Consumption in State

Sales Tax Use Tax

Substantially equivalent amounts are collected by the sales and use taxes. However, proving (as the Secretary attempts to do) that the value of stock and corporate income might have some interrelationship as to amount does not prove that the corporate income tax and the intangibles tax are imposed on substantially equivalent events. The intangibles tax is not necessarily paid on all of the stock of even the wholly foreign corporation (it is paid only on the aggregate value of stock of resident shareholders), and the income tax *does not vary* with the presence of shareholders in the state. Therefore, the two tax bases cannot be equivalent. Due to the total lack of connection of the two tax bases, it is impossible for the resulting taxes to have even the "rough approximation" for which the Secretary argues. Resp. Br. 25. *Cf. Alaska v.*

[7]Not to the contrary is a statement in *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981) that equivalent values indicate complementarily. Resp. Br. 32. The values are equivalent because the items consumed activities are equivalent.

Arctic Maid, 366 U.S. 199 (1961) (upholding a 4% and 6% tax regime, where *both* taxes were imposed on the value of fish).[8]

It is true that the use tax is imposed on the purchase price of goods bought outside the state in part because the sale cannot be constitutionally taxed by the state of use, just as the corporate income earned outside the state cannot be taxed. There is, however, a taxable event - the use of the goods - that occurs in the state; moreover, this use is substantially equivalent to the commencement of use upon a taxable sale in state. In contrast, there is no taxable event in the state by virtue of shareholders residing there that is equivalent to 100% of the corporate income earned in the state.

Analogously, in *Armco, Inc. v. Hardesty*, 467 U.S. 638, 643 (1984), Washington's manufacturing tax was not complementary to its wholesaling tax on imported goods because the manufacturing tax did not fall *only* on goods sold in the state as did the wholesaling tax; thus, the two taxes were not proxies for each other and did not fall on common taxing subject, substantially equivalent events, i.e., sales of goods.

[8]*Arctic Maid* was not a true compensatory tax case because the tax at issue was arguably imposed on a nondiscriminatory class of activities. See Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405, 414, n. 63 (1986).

4. The Secretary asks the Court to uphold a compensatory tax that causes discrimination against interstate commerce.

The Secretary asks this Court to do something it has never done: to approve as a compensatory tax a tax that is part of a scheme that discriminates: ". . . which means that the taxable percentage deduction furthers a legitimate local purpose . . . that cannot be achieved by nondiscriminatory means." Resp. Br. 9.

A compensatory tax cannot be discriminatory in effect against interstate commerce, as illustrated by the Court's discussion of the need for compensatory taxes to satisfy "well understood constitutional strictures" requiring "[E]qual treatment for in-state and out-of-state taxpayers similarly situated"). *Jefferson Lines*, 115 S.Ct. at 1342, n.6. That equal treatment in the sales/use tax case is insured by a credit against the use tax of sales tax paid to another state. Application of a similar mechanism to the North Carolina scheme would require that the intangibles tax deduction include the percentage of corporate income taxed everywhere, which generally would be 100%, thus negating the intangibles tax.

B. Avoiding Double Intrastate Taxation Is No Justification For Higher Taxation of Interstate Commerce.

1. There would be no privileged position for interstate commerce, absent the disputed deduction.

Perhaps recognizing the fallacy of her arguments, the Secretary finally argues that the admittedly discriminatory scheme to avoid double intrastate taxation is necessary to avoid giving a privileged position to interstate commerce. Resp. Br. 9, 44. But there would be no privileged position for interstate commerce if the discriminatory deduction did not exist. The internal consistency analysis shows that if all states adopted a residence based stock tax on 100% of value, and imposed the corporate income tax as commonly exists, then about 100% of corporate income will be taxed in the aggregate and 100% of stock value will be taxed, regardless of the presence or absence of interstate commerce. See Pet. Br. 30-32.

This Court has ruled that a state cannot pursue the goal of eliminating double taxation for intrastate commerce at the expense of causing potentially multiple interstate taxation. *Tyler Pipe Indus. v. Wash. State Dept. of Rev.*, 483 U.S. 232 (1987) involved a state that did not want to double tax manufacturers that sold in the state, so it exempted from the manufacturing tax the goods sold in the state by local manufacturers who were subject to the wholesale tax. The Court struck down that exemption because it created potentially multiple interstate taxation under the internal consistency analysis.

This Court need not decide here whether two states can tax the full value of intangible property in order to rule for Fulton. See Pet. 12. The issue here is not whether North Carolina can tax 100% of the value of stock under the Commerce Clause, possibly resulting in duplicative taxation of stock (a Commerce Clause issue not decided by earlier decisions). The issue, according to the Secretary's own theory which posits the aggregate stock tax as a proxy for a tax on corporate income, is whether corporate income can be indirectly taxed through the stock tax, resulting in multiple interstate taxation of corporate income. Unquestionably, the Commerce Clause forbids such multiple taxation of corporate income. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

2. The State would not be "placed in an insurmountable bind."

The Secretary's Brief states that the alternatives to the North Carolina taxing scheme at issue here would "place the State in an insurmountable bind." Resp. Br. 8. The alternative that the stock tax be eliminated seems to suit at least 38 other states. Br. in Opp. to Pet. 13.

Neither does the alternative of taxing stock at full value create any serious problem. North Carolina already engages in "double intrastate taxation" of corporate income, without being in a bind. North Carolina taxes the incomes of corporations and the dividends received by North Carolina taxpayers from those corporations, thus producing double taxation of the same income. This is

ameliorated only imperfectly and partially by a vestige of a former larger offset, now providing a credit of 6% of dividends to a maximum aggregate $300 per year per shareholder (sheltering a maximum of $4,000 of dividends), allowed only to shareholders of corporations that pay North Carolina corporate income tax on 50% or more of their incomes. N.C. Gen. Stat. §105-151.19.

C. *Darnell* And Related Fourteenth Amendment Cases Are Not Controlling

The Secretary principally relies on *Darnell v. Indiana*, 226 U.S. 390 (1912) and the amicus emphasizes *Darnell* and related cases as they dealt with the issue of "double taxation" within one state. In brief, all of these decisions, with the sole exception of *Darnell's* passing reference to the Commerce Clause, involved the rational relationship test of the Due Process clause. The Court early acknowledged, however, that the failure of a state to take account of taxation by another state was unjust:

> But from the point of view of the taxpayer, it does not matter whether all of his double taxation is done in one state or half in one and half in another. He suffers the same injustice. And, as manifestly the clearest right to tax belongs to the state where the railroad has its tracks, every principle of justice and patriotism would require the same abstinence from taxing stocks of the railroads of neighboring state that is practiced with regard to those of the taxing state - in this case Georgia - itself.

Wright v. Louisville & Nashville Railroad Company, 195 U.S. 219 (1904).

As discussed in Petitioner's Brief, subsequent Commerce Clause rulings of this Court have overtaken any incomplete suggestion in *Darnell* that a state can attempt to avoid alleged multiple intrastate taxation by creating multiple interstate taxation. Pet. Br. 33-34. Indeed, as this Court has recently recognized in *Jefferson Lines*, 115 S. Ct. at 1338, "whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed," that State's tax will violate the "prohibition of multiple taxation."

CONCLUSION

The judgment of the North Carolina Supreme Court should be reversed.

Respectfully submitted, this the 28 day of August, 1995.

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QUESTION PRESENTED

Whether a state may, consistent with the Commerce Clause of the United States Constitution, levy an intangible property tax on ownership of shares of corporate stock where such tax is reduced in an amount directly related to the amount of income of the corporation issuing the stock which is allocated to and taxed in the state.

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No. 94-1239

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1994

FULTON CORPORATION - - - - - - - - *Petitioner*

v.

JANICE H. FAULKNER, Secretary of Revenue - *Respondent*

On Petition for a Writ of Certiorari
to the State of North Carolina

BRIEF AMICUS CURIAE OF THE COMMONWEALTH OF KENTUCKY, REVENUE CABINET, IN SUPPORT OF RESPONDENT

INTEREST OF THE AMICUS CURIAE

The Commonwealth of Kentucky, Revenue Cabinet [hereinafter "Revenue Cabinet"] submits this brief in support of the constitutional validity of the North Carolina intangibles tax levied on ownership of shares of corporate stock. Counsel for Petitioner and Respondent have consented to the filing of this amicus curiae brief. Their letters of consent are being filed with the Clerk of this Court contemporaneously with this brief.

The Revenue Cabinet's interest in the instant case arises from its involvement as the defendant in *St. Ledger* v. *Commonwealth of Kentucky*, 94-SC-875-D & 94-SC-468-DG, currently pending before the Kentucky Supreme Court. The *St. Ledger* plaintiffs contend that Kentucky's method of taxing corporate shares discriminates against interstate commerce by foreclosing tax neutral investment decisions.

Pursuant to KRS 132.020(1) Kentucky taxes non-exempt shares in all corporations at the rate of 25 cents per $100 of value. Appendix [hereinafter App.] 1. The shares tax is not a transaction tax, but is rather an ad valorem tax imposed only on taxable shares with a Kentucky situs held on the January 1 assessment date set forth in KRS 132.190(1). App. 2.

Pursuant to KRS 136.030 Kentucky exempts from the ad valorem tax shares of stock issued by corporations which have paid ad valorem tax to Kentucky on at least 75% of their total property, wherever located, and whether real, tangible or intangible. App. 3. KRS 136.030 makes no distinction based on the state of incorporation, the location of the corporation's headquarters or its principal place of business. The only requirement for exemption pursuant to KRS 136.030 is that the corporation must have paid tax to Kentucky on at least 75% of its property, wherever situated.

The Kentucky Court of Appeals in *St. Ledger, supra,* upheld the Kentucky shares tax scheme on the basis of *Darnell*. *St. Ledger* is currently pending before the Kentucky Supreme Court. Following this court's decision in *Darnell* v. *Indiana*, 226 U.S. 390 (1912), upholding the exemption of domestic shares of stock while taxing foreign shares of stock as "consistent with substantial equality," there were no Commerce Clause challenges to taxes on intangible property for almost 80 years. The Kentucky legislature, like the legislatures of many other states, has

relied upon *Darnell* in drafting its shares tax statutes. Indeed, Kentucky's current scheme was enacted in 1917, only five years after *Darnell* was decided. Moreover, Kentucky courts have sanctioned its shares tax scheme under the applicable state constitutional provisions, and this Court has upheld it against an equal protection challenge. *Klein* v. *Jefferson County Bd. of Tax Supr's*, 230 Ky. 182, 18 S.W.2d 1009 (1929) *aff'd*, 282 U.S. 19 (1930).

It is clear from this Court's holdings in *Darnell* and *Klein* that the purpose of the statutory scheme at issue in this case, as well as Kentucky's KRS 136.030, is to achieve equity by relieving the burden of double taxation which the state property taxes would otherwise impose on in-state holders of the stock of corporations which have paid tax on their property or income within the state. *Darnell*, 226 U.S. at 398, *citing Kidd* v. *Alabama*, 188 U.S. 730 (1903). Kentucky, like many other states, has a policy to alleviate double taxation, a policy which was upheld in *Darnell*. Therefore, the Revenue Cabinet urges this Court to affirm the decision below of the North Carolina Supreme Court for the reasons which follow.

SUMMARY OF ARGUMENT

I. The North Carolina Supreme Court correctly ruled that the shares tax does not violate the Commerce Clause. This Commerce Clause challenge is controlled by *Darnell* v. *Indiana*, 226 U.S. 390 (1912), which held that the taxation of "the property of domestic corporations and the stock of foreign ones in similar cases" is "consistent with substantial equality." *Id.* at 398. As *Darnell* is still good law, and is directly on point with the case at hand, it should be held to be applicable so as to uphold the North Carolina shares tax scheme.

II. The North Carolina shares tax scheme is not facially discriminatory under Commerce Clause jurisprudence

because it does not distinguish between corporations based on whether they are domestic or foreign corporations. It thus does not involve a "direct commercial advantage to local business" not given to out-of-state business. *Maryland* v. *Louisiana*, 451 U.S. 725,754 (1981).

III. The important state interest to avoid double taxation underlies the North Carolina shares tax scheme, and any indirect burden on interstate commerce does not exceed the local benefits. The state's interest is to alleviate the burden of double taxation on the shareholders of corporations which pay income taxes to North Carolina. By allowing the owners of stock of corporations which pay income tax to North Carolina to deduct the percentage of that income tax paid from their intangible property tax bill, North Carolina properly effectuates the important and legitimate state interest of avoiding double taxation.

Moreover, the shares tax scheme does not impose a direct burden on interstate commerce. Here, no out-of-state property is banned from being imported into the state, or taxed solely because of its out-of-state origin. Additionally, neither the statutes nor their application distinguishes between in-state and out-of-state corporations. This Court has recognized that a non-discriminatory intangibles tax on corporations has only an indirect and incidental effect on interstate commerce. *Virginia* v. *Imperial Coal Sales Co.*, 293 U.S. 15 (1934). Thus, because the shares tax does not impose a direct burden on interstate commerce, and is justified by the legitimate state interest of avoiding double taxation, the tax should be upheld as constitutional.

IV. The North Carolina shares tax scheme is internally consistent and there is no risk of multiple taxation because no other state may constitutionally tax the same shares consistent with the requirements of the Due Process and Commerce Clauses because those shares would not have situs in those states.

V. Even if found to be facially discriminatory, the North Carolina shares tax should be upheld under the compensatory tax doctrine because it involves the reduction in the shares tax to the shareholder, is offset proportionally by way of the income tax on the corporation issuing the shares, and thus "imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce . . . " *Oregon Waste Systems, Inc.* v. *Dept. of Environmental Quality*, 511 U.S. ____, 128 L.Ed.2d 13, 23 (1994).

ARGUMENT

THE NORTH CAROLINA SUPREME COURT CORRECTLY RULED THAT THE TAX ON CORPORATE STOCK DOES NOT VIOLATE THE COMMERCE CLAUSE.

A. Fulton Corporation's Commerce Clause Challenge is Controlled by *Darnell* v. *Indiana*.

The instant case involves the North Carolina scheme of taxation of shares of stock owned by North Carolina residents. See N.C.Gen.Stat. §§ 105-203, 105-206 and N.C.Gen.Stat. §§ 105-130.3, 105-130.4, and 105.130.7. Brief for Petitioner, App. at 1a through 10a. In the decision below, the North Carolina Supreme Court set forth the manner in which the intangibles tax on stock is computed:

> the greater the percentage of the issuing corporation's total income which is allocated to and taxed in this state the more dividend income from that corporation a corporate shareholder is allowed to deduct and the less intangibles tax the shareholder pays. The amount by which the intangibles tax against the shareholder is reduced, therefore, is directly related to the amount of the issuing corporation's income which is allocated to and taxed in this state. If 70% of the issuing corporation's income is allocated to North Carolina, then 70% of the dividends on that corporation's stock

> are deductible by the corporate shareholder as income, the stock's value for intangibles tax purposes is reduced by 70%, and the intangibles tax thereby decreased by 70%.

Fulton Corp. v. *Justus*, 338 N.C. 472, 450 S.E.2d 728, 729 (N.C. 1994), *cert. granted sub nom. Fulton Corp.* v. *Faulkner*, 131 L.Ed.2d 554 (1995).

The Supreme Court of North Carolina correctly ruled that *Darnell* v. *Indiana*, 226 U.S. 390 (1912) controls the Commerce Clause challenge to the tax on shares of corporate stock. In *Darnell*, the plaintiff, a resident of Indiana, owned stock in a Tennessee corporation that paid no taxes in Indiana. *Darnell* upheld against a Commerce Clause challenge an Indiana statute which taxed the stock of out-of-state corporations, but not the stock of corporations created under Indiana law. The Indiana Supreme Court held that there was no discrimination because (1) the purposes of the law were "to require all property to contribute pro rata its share of taxes, . . . , and so far as practicable to avoid double taxation," and (2) domestic corporations whose stock was exempt were taxed upon their property in Indiana while non-exempt corporations could not be so taxed on their out-of-state property. *Darnell* v. *Indiana*, 174 Ind. 143, 90 N.E. 769, 774 (1910), *aff'd.*, 226 U.S. 390 (1912).

Upon review, this Court in *Darnell* rejected the contention that taxing foreign corporate shares while exempting domestic corporate shares violated the Commerce Clause, saying that the taxation of "the property of domestic corporations and the stock of foreign ones in similar cases" was "consistent with substantial equality." *Darnell* v. *Indiana*, 226 U.S. at 398. This Court in *Darnell* rejected the argument that the policy against double taxation does not justify the distinction made because the property of the non-domestic corporation is presumably taxed in its home state. *Id.* In so doing the *Darnell* opinion referred to *Kidd* v. *Alabama*, 188 U.S. 730 (1903) and *Wright* v. *Louisville & N. R. Co.*, 195 U.S. 219, 222 (1904) ("A tax in another state is no tax for the purposes of the state of Georgia."). This Court in *Darnell* also rejected the argument that there was discrimination because the Indiana statutes "do not make allowance if a foreign corporation has property taxed within the state," saying that the appellants "do not show that [such a case] is theirs, and that, as they do not belong to the class for whose sake the constitutional protection be given, if it would, they cannot complain on that ground." *Id.* at 398.

The *Darnell* decision directly applies and must be followed in this case. The North Carolina tax scheme is very similar to the tax scheme at issue in *Darnell*.[1] Under the North Carolina tax scheme there is a "reduction in the shares tax to the shareholder which is offset in a direct proportional way to the corporation." *Justus*, 450 S.E.2d at 732. While it is true that *Darnell* involved a property tax on shares of stock to the shareholder which was offset by a property tax to the corporation, that distinction, as the lower court found, is immaterial.

This Court should rule that the lower court properly held that *Darnell* is applicable so as to uphold the constitutionality of the North Carolina taxing scheme. The Indiana Supreme Court recently followed *Darnell* and upheld the same statute involved in *Darnell* against the same Commerce Clause challenge raised by Fulton Corporation. *Indiana Dept. of State Revenue* v. *Felix*, 571 N.E.2d 287 (Ind. 1991), *cert. dismissed*, 502 U.S. 1084 (1992). The Court in *Felix* held that recent Commerce Clause decisions of this Court have not superseded *Darnell*, and that the policy against double taxation is still a sufficient basis to

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[1]The Kentucky shares tax scheme is even more similar to that in *Darnell*; i.e., it involves a property tax to shareholders which is directly offset by a property tax on corporations.

justify a tax offset by the tax paid by domestic corporations. *Felix*, 571 N.E. 2d at 291-92 (citing *Darnell*). This Court has stated that "[i]f a precedent of this [Supreme] Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [the lower courts] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *American Trucking Assns.* v. *Smith*, 496 U.S. 167, 180 (1990). Moreover, this Court has recently indicated that *Darnell* is still good law, see *Oklahoma Tax Comm'n v Jefferson Lines, Inc.*, 514 U.S. ____, 131 L.Ed.2d 261, 276-77, n.6 (1995), and as it is directly on point, it should apply here, so as to support a holding of constitutionality.

B. The North Carolina Shares Tax Scheme is Not Facially Discriminatory.

The Commerce Clause provides that "[t]he Congress shall have power . . . [to] regulate Commerce . . . among the several States." Art. I, § 8, cl. 3. "Though phrased as a grant of regulatory power to Congress, the Clause has long been understood to have a 'negative' aspect that denies the States the power to unjustifiably discriminate against or burden the interstate flow of articles of commerce." *Oregon Waste Systems* v. *Dept. of Environmental Quality*, 511, U.S. ____, ____, 114 S.Ct. 1345, 1349 (1994) (citations omitted).

It is well-established in the law that a taxpayer who is challenging a state tax statute under the Commerce Clause bears the burden of proving that discrimination exists. *See Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534 (1951). Moreover, in a challenge to the facial validity of a statute, a taxpayer must show that "no set of circumstances exists under which the [a]ct would be valid. The fact that [the tax] might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid." *United States* v. *Salerno*, 481 U.S. 739, 745 (1987).

State tax discrimination has been defined as a "direct commercial advantage to local business" not given to out-of-state business. *Maryland* v. *Louisiana*, 451 U.S. 725, 754 (1981). The negative aspect of the Commerce Clause thus "prohibits economic protectionism—that is regulatory measures *designed to benefit in-state economic interests by burdening out-of state competitors,*" *New Energy Co. of Indiana* v. *Limbach*, 486 U.S. 269, 273 (1988), (emphasis added) and prohibits the "differential tax treatment of interstate and intrastate commerce." *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, *reh'g den.*, 453 U.S. 927 (1981). Thus, discriminatory state taxes for purposes of the Commerce Clause are those which "favor local enterprises at the expense of out-of-state businesses . . .". *Boston Stock Exchange* v. *State Tax Comm'n.*, 429 U.S. 318, 328 (1977).

In the recent case of *Oklahoma Tax Comm'n.* v. *Jefferson Lines, supra* at 279-80 this Court upheld an unapportioned state sales tax on the full cost of interstate bus tickets, and restated these principles as follows:

> A State may not 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to a local business.' *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 458, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959); *see also American Trucking Assns. Inc.* v. *Scheiner*, 483 U.S. 266, 269, 97 L. Ed. 2d 226, 107 S. Ct. 2829 (1987). Thus, States are barred from discriminating against foreign enterprises competing with local businesses, *see, e.g., Scheiner, supra*, at 286, 97 L. Ed. 2d 226, 107 S. Ct. 2829, and from discriminating against commercial activity occurring outside the taxing State, *see, e.g. Boston Stock Exchange* v. *State Tax Comm'n.*, 429 U.S. 318, 50 L. Ed. 2d 514, 97 S. Ct. 599 (1977). No argument has been made that Oklahoma discriminates against out-of-state enterprises, and there is no merit

in the argument that the tax discriminates against interstate activity.

This Court's four-prong test for evaluating a challenge under the Commerce Clause is set forth in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, *reh'g den.*, 430 U.S. 976 (1977). A state tax will be held valid with regard to a Commerce Clause challenge if: (1) the tax is applied to an activity having a substantial nexus with the taxing state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state. *Id.* at 277-78. The prong at issue here is the third — whether the tax discriminates against interstate commerce.

For Fulton Corporation to meet its burden of proving state tax discrimination, it must show unequal treatment of different groups of taxpayer corporations. Unequal treatment can arise either on the face of the tax statute or from the impact of a facially neutral statute. The North Carolina shares tax statutes are clearly not facially discriminatory because they do not distinguish between corporations based on the state of incorporation, place of doing business or any other basis. Indeed, all corporations qualify for the exemption from shares tax as long as they meet the statutory requirements regarding income. As a North Carolina corporation, Fulton Corporation is an "insider who presumably [is] able to complain about and change the tax through the [North Carolina] political process." *Goldberg* v. *Sweet*, 488 U.S. 252, 266 (1989). Further, "[I]t is not a purpose of the Commerce Clause to protect state residents from their own taxes." *Id.*

This situation is dramatically different from that present in cases in which this Court has found statutory schemes to be facially discriminatory. For instance, in *Boston Stock Exchange* v. *State Tax Comm'n.*, *supra*, the challenged provisions taxed the in-state sale of stock at a lower rate than the out-of-state sale of stock; in *Welton* v. *Missouri*, 91 U.S. 275 (1876) a license tax was imposed only on itinerant salesmen who sold goods produced outside the state; and in *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64 (1963), a tax statute imposed higher use taxes on out-of-state manufacturers than on in-state manufacturers.

The North Carolina shares tax does not facially discriminate against interstate activity or against out-of-state enterprises competing with local businesses. The imposition of the North Carolina shares tax is not based on the in-state versus out-of-state origin of the shares involved, or on whether the corporation participates in interstate commerce or not. Rather, it is imposed on all shares in all corporations, except for those entities which are entitled to an offset due to the amount of income tax paid to North Carolina. Further, the shares tax confers no "direct competitive advantage on local businesses," *Maryland* v. *Louisiana*, 451 U.S. at 754, because (1) shares of stock are not objects of competition among the corporations which issue them; and (2) the shares tax does not affect the ability of the issuing corporations to compete in in-state or interstate markets. The shares tax simply does not affect the ability of a corporation to compete in interstate commerce because the tax is paid neither by the corporation nor its customers, it does not increase the cost of the corporation's raw materials or services, it does not reduce the corporation's profit margin and it does not give competitors an advantage either in price or net profits.

Thus, because there is no distinction under the North Carolina shares tax scheme between the in-state or out-of-state origin of stock it cannot be held that the tax is a direct burden on interstate commerce. The tax cannot therefore be judged under the standard of per se invalidity which attaches to taxes discriminatory on their face.

C. The Important State Interest to Avoid Double Taxation Underlies the North Carolina Shares Tax Scheme, and any Indirect Burden on Interstate Commerce Does Not Exceed the Local Benefits.

Where the tax at issue has "only indirect effects on interstate commerce," the Court must first consider whether there is a legitimate state interest underlying the statute; if so, then the burden on interstate commerce must "clearly exceed the local benefits" before the taxing statute will be unconstitutional. *Wyoming* v. *Oklahoma*, 502 U.S. 437, 454 n. 12 (1992).

In judging a claim of Commerce Clause discrimination, this Court must review a state tax "in light of its actual effect considered in conjunction with other provisions of the State's tax scheme." *Maryland* v. *Louisiana*, 451 U.S. at 756. In this case, the Court must therefore consider the North Carolina shares tax as an integrated scheme which taxes both domestic and foreign corporations with a substantial nexus to North Carolina. North Carolina taxes domestic and foreign corporations on an equal basis. Both types of entities pay income tax to North Carolina based on the amount of income which they earn. There is no distinction made between domestic and foreign corporations. Shareholders in corporations which earn income in North Carolina are entitled to a reduction in the amount of property tax on those shares which is directly related to the amount of income of the issuer corporation which is taxed in the state. Thus, North Carolina's shares tax scheme does not impose a direct burden on interstate commerce.

Here, no out-of-state property is banned from being imported or taxed solely because of its out-of-state origin. Moreover, neither the statutes at issue nor their application distinguishes between in-state and out-of-state corporations. In *Virginia* v. *Imperial Coal Sales Co.*, *supra*, this

Court recognized that a non-discriminatory intangibles tax on corporations has only an indirect and incidental effect on interstate commerce. Because North Carolina's tax scheme regarding shares of stock has at most an indirect effect on interstate commerce, the standard set forth by this Court in *Wyoming* is applicable here.

The legitimate state interest of the State of North Carolina underlying the tax scheme of shares of stock is to alleviate double taxation. The state's interest is to alleviate the burden of double taxation on the shareholders of corporations which pay income taxes to North Carolina. By allowing the owners of stock of corporations which pay income tax to North Carolina to deduct the percentage of that income tax paid from their intangible property tax bill, North Carolina properly effectuates the important and legitimate state interest of avoiding double taxation.[2] It is well settled in the law that the avoidance of double taxation is a legitimate state interest. *See Klein* v. *Jefferson Co. Board of Tax Supervisors*, 282 U.S. 19 (1930); *Colgate* v. *Harvey*, 296 U.S. 404, 420 (1935).

Indeed, this Court, in *Darnell* v. *Indiana*, *supra*, affirmed the finding of the Indiana Supreme Court that the

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[2]It should be pointed out that Kentucky's tax scheme involving shares of stock does not impose a direct burden on interstate commerce either. Like the North Carolina shares tax scheme, under the Kentucky scheme, no out-of-state property is banned from being imported or taxed solely because of its out-of-state origin. Moreover, the tax scheme does not distinguish among corporations depending on the state where they are incorporated, headquartered, or do business. KRS 136.030 exempts from the tax shares held in corporations, foreign or domestic, which have paid taxes to Kentucky on at least 75% of their property, wherever located. Shares of corporations formed in states other than Kentucky have qualified for the exemption, while the shares of many corporations formed in Kentucky have not.

purpose of the statute which exempted from tax stock of Indiana corporations, while taxing the stock of out-of-state corporations, was "to require all property to contribute pro rata its share of taxes, *and so far as practicable to avoid double taxation.*" *Darnell* v. *State of Indiana*, 90 N.E. 769, 774 (Ind. 1910) (emphasis added). The Indiana Supreme Court recently revisited the intangibles tax issue, and once again found that the policy against double taxation justified the tax scheme:

> The State, in its discretion might tax the shares of stock in [a domestic] corporation to the individual owners thereof residing in this State, but it would in a sense be double taxation, and it has not been the policy of this State to do so. Shares of stock in a foreign corporation doing business in another state, owned and held by a resident of this State, are taxed because they have not been and cannot be otherwise taxed by this State.

Felix, supra at 290 (quoting *Darnell*, 90 N.E. at 774).

The North Carolina shares tax clearly is *not* "designed to benefit in-state economic interests by burdening out-of-state competitors." *Wyoming* v. *Oklahoma*, 502 U.S. 437 (1992). The North Carolina shares tax scheme thus does not impose a direct burden upon interstate commerce, and is justified by the legitimate state interest of avoiding double taxation. This Court should affirm the North Carolina Supreme Court's decision holding that the tax scheme does not violate the Commerce Clause.

D. The North Carolina Shares Tax Scheme Is Internally Consistent.

Under the internal consistency test a tax "must be such that, if applied by every jurisdiction, there would be no impermissible interference with free trade." *Armco* v. *Hardesty*, 467 U.S. 638, 644 (1984). Here, North Carolina's shares tax system is the epitome of fair apportionment

and internal consistency. There is no risk of multiple taxation of the same property if other states adopted this system because North Carolina can only tax those shares which have a situs in the state on the assessment date. No other state may constitutionally tax the same shares consistent with the requirements of the Due Process and Commerce Clauses because those shares would not have a jurisdictional situs in those other states. *Norfolk & Western R. Co.* v. *Missouri Tax Commissioner*, 390 U.S. 317, 325 (1968). In *Norfolk & Western R. Co.* the Court held that "the taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is due." *Id.* Thus, the internal consistency test is irrelevant to an ad valorem tax which is expressly limited to property with a North Carolina situs.

E. The North Carolina Shares Tax Scheme is Compensatory in Nature and Thus Should be Upheld as Constitutional.

The North Carolina Supreme Court properly held that the shares tax is a valid compensatory tax. Under the compensatory tax doctrine "a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause." *Oregon Waste Systems, Inc.* v. *Dept. of Environmental Quality*, 511 U.S. ___, ___, 128 L. Ed.2d 13, 23 (1994). An apparently discriminatory tax will be upheld where it is "designed simply to make interstate commerce bear a burden already borne by intrastate commerce." *Associated Industries of Missouri* v. *Lohman*, 511 U.S. ___, ___, 128 L.Ed.2d 639, 647 (1994).

An apparently discriminatory tax was upheld under the compensatory tax doctrine in *Henneford* v. *Silas Ma-*

son Co., 300 U.S. 577 (1937) which established the constitutionality of compensatory use taxes. The rationale set forth in that decision is applicable here. In *Henneford* the state of Washington imposed a use tax on property purchased outside the state on which no sales tax had been paid. The purpose of the tax was to compensate for Washington's sales tax by imposing a tax equal in amount to the sales tax that would have been imposed on the sale if it had occurred within the state. The use tax thus effectively applied only to goods purchased out-of-state or in interstate commerce, since any in-state purchase would already have been subjected to sales tax and thus would have been exempted from use tax. Despite the facial discrimination in the use tax, this Court sustained it because the "practical effect" of the overall tax structure imposed a burden on the out-of-state purchase of goods identical to that imposed on an equivalent in-state purchase. *Henneford*, 300 U.S. at 581. *See also Dunbar-Stanley Studios, Inc.* v. *Alabama*, 393 U.S. 537 (1969); (tax on transient photographers compensated by tax on photographers conducting business from a fixed location); *Alaska* v. *Arctic Maid*, 366 U.S. 199 (1961) (business license tax on freezer ships compensated by tax on local canners).

In *Artic Maid*, the Court upheld a tax on freezer ships obtaining fish for freezing, in part because local canners were subjected to even higher taxes. The Court focused on identifying the competitors of the freezer ships, which were determined to be the Alaskan canners, and not the businesses which froze fish for the local retail market. Local fish processors selling to the consumer market were subjected to a lower tax than the freezer ships, but the canners were subjected to a higher tax than the freezer ships. *Id.* at 204. The *Artic Maid* rationale thus suggests that it is crucial to assess the competitive effects in determining whether two taxes are compensatory in nature.

Similarly, in *Darnell* v. *Indiana*, Justice Holmes applied the compensatory tax doctrine to uphold the tax when he observed that the state's taxation of "the property of domestic corporations and the stock of foreign ones" was "consistent with substantial equality notwithstanding the technical differences." 226 U.S. at 398. Moreover, the Indiana Supreme Court clearly regarded *Darnell* as involving the application of the compensatory tax doctrine. 571 N.E.2d at 291.

Thus, as the North Carolina Supreme Court concluded, even if the shares tax scheme were determined to be discriminatory, it must be upheld as a compensatory tax. That court's analysis of the compensatory tax doctrine in relation to the North Carolina shares tax scheme was correct and should be applied by this Court:

> In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of 'compensating' tax scheme the Supreme Court upheld in *Darnell*."

Fulton Corp. v. *Justus*, 450 S.E. 2d at 732.

The fact that the North Carolina shares tax scheme does not involve the offset of a property tax on the shareholder against a property tax on the corporation does not prohibit the application of the compensatory tax doctrine. Moreover, there is no constitutional or equitable reason to require a state to extend the credit or exemption to taxes paid to other states because the same taxpayer has not paid both taxes. Although the state, which would other-

wise receive the benefit of the double taxation, may choose to allow a credit or exemption even where the taxes creating the double taxation problem are paid to it by different taxpayers (the corporation and its equity owners), it is not constitutionally compelled to extend that same treatment to taxes of which it has not received the benefit. Thus, when the third party taxpayer (the issuer corporation) has paid the taxes to a second state, the taxing state may properly recognize the difference in taxpayers and decline to treat the situation as the same sort of double taxation in which it has received taxes on both forms of wealth.

This Court should reject Petitioner's call for abandonment of the less restrictive compensatory tax theory created by *Darnell* for ad valorem taxation of shares of stock. State ad valorem taxes on shares of stock should not be required to meet the strict standards for compensatory taxes which have been established for other taxes. Such taxes do not present the same double taxation inequities inherent in taxation of shares of stock. Shares of stock, by their nature, are representative of value which derives from other sources which may themselves have already been taxed. Where a state's own tax laws create such an inequity as double taxation, that state should be free to alleviate it on a non-discriminatory basis by making the same exemption available to holders of stock of corporations without regard to state of incorporation, and without being required, as a price for pursuing fairer tax laws, to alleviate inequities of which it has not received a benefit and which are not of its own making but rather are caused by the tax laws of other states.

Fulton Corporation's argument would render illegitimate the purpose of North Carolina, Kentucky and other states to achieve greater tax equity in their shares tax schemes. If Fulton Corporation's argument were accepted by the Court, it would force the taxing state to choose

between an unfair taxing scheme encompassing double taxation or to forego entirely this revenue source in favor of an even more unfair tax scheme which arbitrarily allows owners of corporate shares to escape the ad valorem taxes by which holders of all other forms of wealth are required to support the common government.

If the shares tax schemes in place in many states were stricken as violative of the Commerce Clause, the ability of state legislatures to fashion equitable systems of property taxation as mandated by state constitutions would be crippled.[3] Fulton Corporation's argument should not be accepted because it is based on an interpretation of this Court's Commerce Clause jurisprudence, which is unwarranted and which would produce inequitable results. States have for decades justifiably relied on this Court's decisions in *Darnell* and *Klein* in enacting these tax schemes. Because the instant case "involves a reduction in the shares tax to the shareholder which is offset in a direct proportional way by an income tax to the corporation," *Justus*, 450 S.E.2d at 732, the compensatory tax doctrine should be applied by this Court to uphold the North Carolina shares tax scheme.

Moreover, any change in the law involving the abandonment of the rule of *Darnell* should not be applied retroactively, either to the parties before this Court or to other entities, such as the Commonwealth of Kentucky, which might be affected by such a ruling. *Chevron Oil Corp.* v. *Huson*, 404 U.S. 97 (1971); *American Trucking Assns.* v. *Smith*, *supra*.

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[3]For example, Ky.Const. § 172 mandates that:

> "All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale..."

CONCLUSION

For all of the foregoing reasons, the judgment of the North Carolina Supreme Court should be affirmed.

Respectfully submitted,

JENNIFER SARTOR SMART
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APPENDIX

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1. **KRS 132.020(1)**

   An annual ad valorem tax for state purposes of thirty-one and one-half cents ($0.315) upon each one hundred dollars ($100) of value of all real property directed to be assessed for taxation, and one and one-half cents ($0.015) upon each one hundred dollars ($100) of value of all privately-owned leasehold interests in industrial buildings, as defined under KRS 103.200, owned and financed by a tax-exempt governmental unit, or tax-exempt statutory authority under the provisions of KRS Chapter 103 directed to be assessed for taxation, except that the rate shall not apply to the proportion of value of the leasehold interest created through any private financing, and one and one-half cents ($0.015) upon each one hundred dollars ($100) of value of all tobacco directed to be assessed for taxation, and *twenty-five cents ($0.25) upon each one hundred dollars ($100) of value of all money in hand, shares of stock, notes, bonds, accounts, and other credits, whether secured by mortgage, pledge, or otherwise, or unsecured,* except as otherwise provided in subsection (2) of this section, and one and one-half cents ($0.015) upon each one hundred dollars ($100) of value of unmanufactured agricultural products, one-tenth of one cent ($0.001) upon each one hundred dollars ($100) of value of all farm implements and farm machinery owned by or leased to a person actually engaged in farming and used in his farm operations, one-tenth of one cent ($0.001) upon each one hundred dollars ($100) of value of all livestock and domestic fowl, one-tenth of one cent ($0.001) upon each one hundred dollars ($100) of value of all tangible personal property located in a foreign trade zone as designated under 19 U.S.C. Sec. 81, fifteen cents ($0.15) upon machinery of individuals or corporations actually engaged in manufacturing, fifteen cents ($0.15) upon commercial radio, television and telephonic equipment directly used or associated with electronic equipment

which broadcasts electronic signals to an antenna, fifteen cents ($0.15) upon property which has been certified as a pollution control facility as defined in KRS 224.01-300, one-tenth of one cent ($0.001) upon property which has been certified as an alcohol production facility as defined in KRS 247.910, or as a fluidized bed energy production facility as defined in KRS 211.390, twenty-five cents ($0.25) upon each one hundred dollars ($100) of value of motor vehicles qualifying for permanent registration as historic motor vehicles under the provisions of KRS 186.043, and forty-five cents ($0.45) upon each one hundred dollars ($100) of value of all other property directed to be assessed for taxation shall be paid by the owner or person assessed except as provided in subsection (2) of this section and KRS 132.030, 132.050, 132.200, 136.270, 136.300, 136.320, and other sections providing a different tax rate for particular property. (emphasis added)

2. KRS 132.190(1)

The property subject to taxation, unless exempted by the Constitution, shall be as follows:

(a) All real and personal property within this state, including intangible personal property of nonresidents and corporations not organized under the laws of this state that has acquired a business situs within this state, except that twenty-five (25) domestic fowl to each family shall be exempt from taxation for any purpose.

(b) All intangible personal property of individuals residing in this state and of corporations organized under the laws of this state unless it has acquired a business situs without this state.

3. KRS 136.030(1)

The individual stockholders of a corporation shall not be required to list their shares for ad valorem taxation

so long as the corporation pays taxes to the State of Kentucky on at least seventy-five percent (75%) of its total property, wherever located. Bonds and obligations of the United States of America and its possessions and bonds and obligations of the State of Kentucky, its instrumentalities, and its political subdivisions and their instrumentalities shall not be considered in the computation of the total property of the corporation, wherever located, nor in the computation of the amount of property upon which the corporation pays ad valorem taxes to the State of Kentucky. In order to obtain this exemption, the stockholder shall furnish satisfactory proof to the Revenue Cabinet that at least seventy-five percent (75%) of the total property of the corporation as hereinabove specified is taxed in the State of Kentucky.